

SECTION 13. TAX PROVISIONS RELATED TO RETIREMENT, HEALTH, POVERTY, EMPLOY- MENT, DISABILITY AND OTHER SOCIAL ISSUES

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INTRODUCTION

The preceding sections of this publication discuss direct payments to individuals for retirement, health, public assistance, employment, and disability benefits provided through entitlement programs within the jurisdiction of the Committee on Ways and Means. The Federal Government also provides benefits to individuals through elements of the income tax set forth in the Internal Revenue Code of 1986 (the Code). The Code is entirely within the jurisdiction of the Committee on Ways and Means.

TAX PROVISIONS

Several different types of income tax provisions are available to provide economic incentives. Examples include: exclusions, exemptions, deductions, preferential rates, deferrals and credits (see Joint Committee, 1996). Measuring the amount of benefit afforded by a tax provision is difficult. However, one way to measure the benefit is to review the total estimated amounts excluded, exempted, or otherwise afforded special treatment under various provisions of the income tax.

USE OF DISTRIBUTIONAL ANALYSIS

Analyzing the effectiveness of tax provisions at achieving their policy goals often involves examining the distribution of benefits from the provisions allocated by the income class of those who take advantage of the provisions. The income concept used to show the distribution of tax expenditures by income class is adjusted gross income plus: (1) tax-exempt interest; (2) employer contributions for health plans and life insurance; (3) employer share of FICA taxes; (4) workers' compensation; (5) nontaxable Social Security benefits; (6) insurance value of Medicare benefits; (7) minimum tax preferences; and (8) excluded income of U.S. citizens living abroad.

This definition of income includes items that clearly increase the ability to pay taxes, but that are not included in the definition of adjusted gross income. However, it omits certain items that clearly affect ability to consume goods and services either now or in the future, including accrual of pension benefits, other fringe benefits (such as military benefits, veterans benefits, and parsonage allowances), and means-tested transfer payments (such as AFDC, Supplemental Security Income, food stamps, housing subsidies, and general assistance).

The tax return is the unit of analysis. Table 13-1 shows the distribution of all tax returns for 1997 by income class.

Unless specifically indicated, all distributional tables exclude returns filed by dependents. All projections of income and deduction items and tax parameters are based on economic assumptions consistent with the December 1996 forecast of the Congressional Budget Office.

TABLE 13-1.—DISTRIBUTION OF TAX RETURNS BY INCOME CLASS, 1997

Income class (thousands) ¹	All returns ²	Taxable returns	Itemized returns	Tax liability
Below \$10	21,496	1,642	130	— \$5,364
\$10–\$20	24,714	9,122	921	— 4,029
\$20–\$30	19,926	12,990	2,156	16,455
\$30–\$40	16,441	13,966	3,399	33,817
\$40–\$50	12,449	11,502	3,947	40,823
\$50–\$75	19,605	19,397	10,041	108,548
\$75–\$100	9,241	9,206	6,975	92,691
\$100–\$200	7,310	7,293	6,441	145,699
\$200 and over	1,648	1,644	1,527	208,042
Total	132,830	86,763	35,537	636,683

¹ The income concept is defined at the beginning of this chapter.

² Includes filing and nonfiling units. Filing units include all taxable and nontaxable returns. Nonfiling units include individuals with income that is exempt from Federal income taxation (e.g., transfer payments, interest from tax-exempt bonds, etc.). Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.

Note.—Money amounts in millions of dollars, returns in thousands. Detail may not add to total due to rounding.

Source: Joint Committee on Taxation.

TAX PROVISION ESTIMATES

Table 13-2 provides various estimates for 33 tax provisions related to retirement, health, poverty, employment, disability, and housing. These provisions are examined in detail in this chapter including their legislative history, an explanation of current law, and a brief assessment of their effects.

NET EXCLUSION OF PENSION CONTRIBUTIONS AND EARNINGS

LEGISLATIVE HISTORY

Prior to 1921, no special tax treatment applied to employee retirement trusts. Retirement payments to employees and contributions to pension trusts were deductible by the employer as an ordinary and necessary business expense. Employees were taxed on amounts actually received as well as on employer contributions to a trust if there was a reasonable expectation of benefits accruing from the trust. The 1921 Code provided an exemption for a trust forming part of a qualified profit sharing or stock bonus plan.

The rules relating to qualified plans were substantially revised by the Employee Retirement Income Security Act of 1974 (ERISA), which added overall limitations on contributions and benefits and other requirements on minimum participation, coverage, vesting, benefit accrual, and funding. Further revisions of these rules have been made in every major tax bill enacted after 1974.

TABLE 13-2.—ESTIMATED TAX BASE EXCEPTIONS AND CREDITS UNDER THE PRESENT INCOME TAX FOR VARIOUS ITEMS,¹ CALENDAR YEARS 1998–2002

[In billions of dollars]

Item	Year				Total 1998-2002	
	1998	1999	2000	2001		2002
I. Tax base exceptions related to:						
Retirement:						
Net exclusion of pension contributions and earnings	\$320.0	\$333.7	\$348.0	\$347.7	\$342.1	\$1,691.5
Keogh plans	19.6	20.9	22.2	23.6	25.1	111.4
Individual retirement plans	49.8	52.3	55.2	58.4	62.8	278.5
Exclusion of Social Security and railroad retirement benefits in excess of employee share of payroll tax ²	262.4	272.0	281.9	292.0	302.5	1410.8
Health:						
Exclusions of employer contributions for medical care, health insurance premiums and long-term care insurance premiums ³	248.2	260.0	272.7	286.4	301.6	1,369.0
Exclusion of Medicare benefits:						
Medicare part A	135.6	146.8	158.8	171.1	184.4	796.7
Medicare part B	63.2	70.5	78.5	86.2	94.6	393.0
Deductibility of medical expenses ⁴	34.7	37.8	40.9	44.8	48.7	206.9
Deductibility of health insurance expenses of the self- employed ⁵	5.3	5.8	6.9	7.4	9.4	34.8
Exclusion of accelerated death benefits	1.1	1.4	1.7	2.1	2.5	8.8
Poverty:						
Exclusion of public assistance and SSI cash benefits	51.1	52.5	55.7	54.6	59.1	273.0
Employment:						
Exclusion of employer-provided dependent care ⁶	5.2	6.0	6.6	6.9	7.1	31.8
Employee stock ownership plans (ESOPs)	11.6	12.5	13.3	14.0	14.7	66.1

Exclusion for benefits provided under cafeteria plans ⁷	29.6	33.3	36.6	40.2	44.2	184.0
Elderly and disabled:						
Exclusion of workers' compensation and special benefits for disabled coal miners:						
Workers' compensation	30.7	31.5	32.5	33.2	34.0	161.9
Special benefits for disabled coal miners	1.1	1.0	1.0	1.0	0.9	5.0
Additional standard deduction for elderly and blind	12.3	12.9	13.8	14.6	15.8	69.4
Housing:						
Deductibility of mortgage interest	168.9	174.9	181.0	187.9	194.6	907.3
Deductibility of property tax on owner-occupied housing	69.2	72.7	75.9	80.1	84.5	382.4
Exclusion of interest on State and local government bonds for owner-occupied housing	7.9	8.4	8.4	8.5	8.5	41.7
Depreciation of rental housing in excess of alternative depreciation system	9.2	8.4	8.3	8.6	9.6	44.1
Exclusion of interest on State and local government bonds for rental housing	3.6	3.7	3.6	3.5	3.4	17.9
Families:						839
Qualified State tuition programs and education IRAs	0.4	0.5	0.7	0.8	1.1	3.5
Student loan interest deduction	0.1	0.1	0.1	0.2	0.3	0.8
Employer-provided adoption expenses	(⁸)	(⁸)	(⁸)	(⁸)	(⁸)	(⁸)
II. Tax credits related to:						
Poverty:						
Earned income credit:						
Nonrefundable portion	22.5	23.4	24.4	25.3	26.4	122.0
Refundable portion	5.2	5.3	5.5	5.9	6.1	28.0
Employment:						
Dependent care credit	2.7	2.8	2.9	2.9	3.0	14.3
Work opportunity tax credit	0.2	0.1	(⁸)	(⁸)	(⁸)	0.4
Welfare-to-work tax credit	(⁸)	(⁸)	(⁸)	(⁸)	(⁸)	0.1
Elderly and disabled:						
Tax credit for elderly and disabled	(⁸)	(⁸)	(⁸)	(⁸)	(⁸)	0.1

TABLE 13-2.—ESTIMATED TAX BASE EXCEPTIONS AND CREDITS UNDER THE PRESENT INCOME TAX FOR VARIOUS ITEMS,¹ CALENDAR YEARS 1998–2002—Continued

[In billions of dollars]

Item	Year					Total 1998–2002
	1998	1999	2000	2001	2002	
Housing:						
Low-income housing tax credit	3.2	3.5	3.9	4.3	4.6	19.6
Families:						
Child tax credit:						
Nonrefundable portion	16.6	20.5	20.4	20.2	19.8	97.5
Refundable portion	0.9	1.1	1.1	1.1	1.1	5.3
HOPE credit and lifetime learning credit	6.2	6.3	7.2	7.7	7.6	35.1
Adoption credit	0.4	0.4	0.4	0.2	0.2	1.5

¹ Estimates of exclusions and deductions represent changes in the tax base; they do not measure changes in tax liability. Tax effects of provisions are not comparable.

² In addition to OASDI benefits for retired workers, these figures also include disability insurance benefits and benefits for dependents and survivors.

³ Estimate includes employer-provided health insurance purchased through cafeteria plans and health care spending through flexible spending accounts.

⁴ Amounts reported on tax returns in excess of the medical deductions floor (7.5 percent of adjusted gross income).

⁵ Amounts deductible from gross income: 45 percent of health insurance expenses in 1998 and 1999, 50 percent in 2000 and 2001, and 60 percent in 2002. Remaining amounts are deductible on schedule A with other itemized medical expenses.

⁶ Estimate includes employer-provided child care purchased through dependent care flexible spending accounts.

⁷ Estimate includes amounts of employer-provided health insurance purchased through cafeteria plans and employer-provided child care purchased through dependent care flexible spending accounts. These amounts are also included in other line items in this table.

⁸ Less than \$50 million.

Note.—Details may not add to totals due to rounding.

Source: Joint Committee on Taxation.

Since ERISA, Congress has also acted to broaden the range of qualified plans. In the Revenue Act of 1978, Congress provided special rules for qualified cash or deferred arrangements under section 401(k). Under these arrangements, known popularly as 401(k) plans, employees can elect to receive cash or have their employers contribute a portion of their earnings to a qualified profit sharing, stock bonus, or pre-ERISA money purchase pension plan.

An employee stock ownership plan (ESOP) is a special type of qualified plan that is designed to invest primarily in securities of the employer maintaining the plan. Certain qualification rules and tax benefits apply to ESOPs that do not apply to other types of qualified plans.

EXPLANATION OF PROVISION

In general

Under a plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (sec. 401(a)), an employer is allowed a deduction for contributions to a tax-exempt trust to provide employee benefits. Similar rules apply to plans funded with annuity contracts. An employer that makes contributions to a qualified plan in excess of the deduction limits is subject to a 10-percent excise tax on such excess (sec. 4972).

The qualification rules limit the amount of benefits that can be provided through a qualified plan and require that benefits be provided on a basis that does not discriminate in favor of highly compensated employees. In addition, qualified plans are required to meet minimum standards relating to participation (the restrictions that may be imposed on participation in the plan), coverage (the number of employees participating in the plan), vesting (the time at which an employee's benefit becomes nonforfeitable), and benefit accrual (the rate at which an employee earns a benefit). Also, minimum funding standards apply to the rate at which employer contributions are required to be made to certain plans to ensure the solvency of pension plans.

If a defined benefit pension plan is terminated, any assets remaining after satisfaction of the plan's liabilities may revert to the employer. Such reversions are included in the gross income of the employer and are subject to income tax plus an additional excise tax (sec. 4980). The excise tax is 20 percent if the employer establishes a qualified replacement plan or provides certain benefit increases. Otherwise, the excise tax is 50 percent. Transfers of excess assets can be made from an ongoing defined benefit plan to pay certain retiree health benefits if certain requirements are satisfied (sec. 420). The assets transferred are not includable in the income of the employer or subject to the tax on reversions.

Minimum participation rules

A qualified plan generally may not require as a condition of participation that an employee complete more than 1 year of service or be older than age 21 (sec. 410(a)).

Vesting rules

A plan is not a qualified plan unless a participant's employer-provided benefit vests at least as rapidly as under one of two alternative minimum vesting schedules (sec. 411).

Benefit accrual rules

The protection afforded employees under the minimum vesting rules depends not only on the minimum vesting schedules, but also on the accrued benefits to which these schedules are applied. In the case of a defined contribution plan, the accrued benefit is the participant's account balance. In the case of a defined benefit plan, a participant's accrued benefit is determined under the plan benefit formula, subject to certain restrictions. In general, the accrued benefit is defined in terms of the benefit payable at normal retirement age and does not include certain ancillary nonretirement benefits.

Each defined benefit plan is required to satisfy one of three accrued benefit tests. The primary purpose of these tests is to prevent undue backloading of benefit accruals (i.e., by providing low rates of benefit accrual in the employee's early years of service when the employee is most likely to leave and by concentrating the accrual of benefits in the employee's later years of service when he is most likely to remain with the employer until retirement) (sec. 412).

Coverage rules

A plan is not qualified unless the plan satisfies at least one of the following coverage requirements: (1) the plan benefits at least 70 percent of all nonhighly compensated employees, (2) the plan benefits a percentage of nonhighly compensated employees that is at least 70 percent of the percentage of highly compensated employees benefiting under the plan, or (3) the plan meets an average benefits test (sec. 410(b)). In addition, a plan is not a qualified plan unless it benefits the lesser of: (1) 50 employees, or (2) 40 percent of the employees of the employer (sec. 401(a)(26)). For years beginning after 1996, pursuant to the Small Business Job Protection Act of 1996, the latter rule is modified to apply only to defined benefit plans. For years beginning after 1996, a defined benefit plan is not a qualified plan unless it benefits at least the lesser of: (1) 50 employees, or (2) the greater of 40 percent of the employees of the employer or 2 employees (or if there is only 1 employee, such employee).

General nondiscrimination rule

In general, a plan is not a qualified plan if the contributions or benefits under the plan discriminate in favor of highly compensated employees (sec. 401(a)(4)).

Limitations on contributions and benefits

The maximum annual benefit that may be provided by a defined benefit pension plan (payable at the Social Security retirement age) is the lesser of 100 percent of average compensation, or \$125,000 for 1997 (sec. 415(b)). The dollar limit is adjusted annually for inflation. The dollar limit is reduced if payments of benefits begin be-

fore the Social Security retirement age and increased if benefits begin after the Social Security retirement age.

Funding rules

Pension plans are required to meet a minimum funding standard for each plan year (sec. 412). In the case of a defined benefit pension plan, an employer must contribute an annual amount sufficient to fund a portion of participants' projected benefits determined in accordance with one of several prescribed funding methods, using reasonable actuarial assumptions. Plans with asset values of less than 100 percent of current liabilities are subject to additional, faster funding rules.

Taxation of distributions

An employee who participates in a qualified plan is taxed when the employee receives a distribution from the plan to the extent the distribution is not attributable to employee contributions (sec. 402). With certain exceptions, a 10-percent additional income tax is imposed on early distributions from a qualified plan (sec. 72(t)). A 15-percent excise tax is imposed on distributions that exceed a certain amount in any year (sec. 4980A). Section 4980A was repealed by the Taxpayer Relief Act of 1997 for excess distributions received after December 31, 1996.

Failure to satisfy qualification requirements

If a plan fails to satisfy the qualification requirements, the trust that holds the plan's assets is not tax exempt. An employer's deduction for plan contributions is only allowed when the employee includes the contributions or benefits in income, and benefits generally are includable in an employee's income when they are no longer subject to a substantial risk of forfeiture.

SIMPLE retirement plans

The Small Business Job Protection Act of 1996 created a simplified retirement plan for small business called the Savings Incentive Match Plan for Employees (SIMPLE) (secs. 408(p) and 401(k)(11)). SIMPLE plans may be adopted by employers with 100 or fewer employees and who do not maintain another employer-sponsored retirement plan. A SIMPLE plan can be either an individual retirement arrangement (IRA) for each employee or part of a qualified cash or deferred arrangement (401(k) plan). If established in IRA form, a SIMPLE plan is not subject to the non-discrimination rules generally applicable to qualified plans and simplified reporting requirements apply. If adopted as part of a 401(k) plan, the plan does not have to satisfy the special non-discrimination tests applicable to 401(k) plans and is not subject to the top-heavy rules. The other qualified plan rules continue to apply. SIMPLE plans are subject to special rules regarding eligibility of employees to participate and special contribution limits.

EFFECT OF PROVISION

The tax treatment of pension contributions and earnings has encouraged employers to establish qualified retirement plans and to compensate employees in the form of pension contributions to such

plans. There are two potential tax advantages of being compensated through pension contributions. One advantage is the ability to earn tax-free returns to savings. When saving is done through a pension plan, the employee earns a higher rate of return than on fully taxed savings.¹ The second advantage is that an employee's tax rate may be lower during retirement than during the working years.

These tax provisions directly benefit only persons who work for employers with qualified plans and who work for a sufficient period of time before their benefits vest in such plans. The current extent of this coverage and recent trends in coverage are described below.

COVERAGE

The term covered, as used here, means that an employee is accruing benefits in an employer pension or other retirement plan. The best current comprehensive evidence on pension coverage comes from a supplement to the April 1993 Current Population Survey (U.S. Department of Labor, 1994). The data referred to below come from that survey unless otherwise noted.

As of April 1993, 63 percent of full-time wage and salary workers employed in the private sector reported that they worked in firms with an employer-sponsored pension plan. Half of the full-time wage and salary workers employed in the private sector were covered by an employer-sponsored pension plan. Most of these workers were covered by basic defined benefit or defined contribution plans (23 percent), and another 10 percent had both a basic plan and a 401(k) type contributory plan (see table 13-3).² For another 17 percent, the 401(k) type plan was their only retirement plan.

Pension coverage varies substantially among full-time, privately employed workers. Differences depend on the age of the worker, job earnings, the industry of employment, and the size of the firm.

Younger workers are much less likely to be covered by a pension than middle aged and older workers. Coverage rates rise steadily from 21 percent for those under age 25 to about 60 percent for those between ages 40 and 60 before falling off somewhat. This pattern holds for both men and women. However, the jump in coverage for middle aged men is slightly larger than the increase for middle aged women (see table 13-4).

Higher paying jobs are more likely to offer pensions. Just 8 percent of full-time private wage and salary workers earning less than \$10,000 per year in 1993 were covered compared to 81 percent of those earning \$50,000 or more (see table 13-5). Coverage may be higher for higher paying jobs because of the greater value of the pension tax benefits to workers in higher tax brackets and because of the declining replacement rate of Social Security at higher earnings levels.

¹ This applies to pension contributions made by employers. Employees may also be able to contribute to qualified plans. Employee contributions may be made with aftertax dollars. If so, the tax advantage given to these contributions is smaller than the tax advantage given to employer contributions, and consists of the deferral of tax on accumulated earnings.

² Some private-sector employees contribute to 403(b) tax-sheltered annuities instead of 401(k) plans.

TABLE 13-3.—EMPLOYER SPONSORSHIP AND EMPLOYEE COVERAGE UNDER PENSION OR RETIREMENT PLAN, PRIVATE WAGE AND SALARY WORKERS

[Percent]

	Total	Full time	Part time
Employer sponsorship:			
Employer sponsors plan	58	63	37
Basic pension only	24	24	23
Basic and 401(k) type	14	16	4
401(k) type only	21	23	10
Employer does not sponsor	35	32	49
Does not know	7	5	14
Employee coverage:			
Employee covered under plan	43	50	12
Basic pension only	20	23	7
Basic and 401(k) type	8	10	2
401(k) type only	15	17	4
Employee is not covered	50	44	73
Does not know	7	6	14
Number of private wage and salary workers (in thousands)	88,679	72,752	15,927

Source: U.S. Department of Labor, 1994, tables A2, B1, B2.

TABLE 13-4.—COVERAGE UNDER EMPLOYER-SPONSORED PENSION OR RETIREMENT PLANS FOR FULL-TIME PRIVATE WAGE AND SALARY WORKERS

Age (in years)	Percent covered		
	Total	Men	Women
Under 25	21	19	22
25-29	41	41	42
30-34	50	50	51
35-39	54	57	51
40-44	58	61	54
45-49	63	66	59
50-54	61	60	62
55-59	59	60	57
60-64	56	59	52
65 or older	46	54	34
Total	50	51	48

Source: U.S. Department of Labor, 1994, table B5.

TABLE 13-5.—COVERAGE UNDER EMPLOYER-SPONSORED PENSION OR RETIREMENT PLANS FOR FULL-TIME PRIVATE WAGE AND SALARY WORKERS BY WORKERS' WAGES

Wages	Percent covered		
	Total	Men	Women
Under \$10,000	8	7	9
\$10,000–\$14,999	27	21	31
\$15,000–\$19,999	42	35	49
\$20,000–\$24,999	57	51	65
\$25,000–\$29,999	62	61	64
\$30,000–\$34,999	67	66	71
\$35,000–\$39,999	73	74	72
\$40,000–\$49,999	78	79	77
\$50,000–\$74,999	81	81	80
\$75,000 or over	81	82	78
Total ¹	50	51	48

¹ Total includes workers not responding on wages, not shown separately.

Source: U.S. Department of Labor, 1994, table B11.

Industries with high pension coverage include manufacturing, mining, financial services, and communications and public utilities. Coverage rates exceed 60 percent for full-time private wage and salary workers in each of these industries (U.S. Department of Labor, 1994, pp. B-8 & B-9). In contrast, coverage rates are under 35 percent in agriculture, retail trade, and construction. Part of the difference among industries appears to be due to differences in firm size. Coverage is much lower for smaller firms. Smaller firms are less likely to offer comprehensive fringe benefit packages as part of total compensation. Only 13 percent of full-time private wage and salary workers in firms with fewer than 10 employees are covered. The rate rises with employer size but does not reach 50 percent (the average across all firm sizes) until firms have 100 or more employees (table 13-6).

Significant differences in coverage also are apparent between full-time private wage and salary workers and other wage and salary workers. Coverage is much lower among part-time workers and much higher among public employees. Among part-time, private wage and salary workers, 12 percent are covered. Seventy-seven percent of public sector wage and salary workers are covered including 85 percent of those who are full-time workers (see table 13-7).

TRENDS IN COVERAGE

At the outset of World War II, private employer pensions were offered by about 12,000 firms. Pensions spread rapidly during and after the war, encouraged by high marginal tax rates and wartime wage controls that exempted pension benefits. By 1972, when the first comprehensive survey was undertaken, 48 percent of full-time private employees were covered. Subsequent surveys found that coverage reached 50 percent in 1979, but by 1983 had fallen back to 48 percent. The decline continued in the 1980s, reaching 46 per-

cent in 1988 (Woods, 1989, p. 17). By 1993, coverage had returned to 50 percent.

TABLE 13-6.—COVERAGE UNDER EMPLOYER-SPONSORED PENSION OR RETIREMENT PLANS FOR FULL-TIME PRIVATE WAGE AND SALARY WORKERS BY SIZE OF FIRM

Firm size (number of workers)	Percent covered		
	Total	Men	Women
Fewer than 10	13	12	14
10-24	25	23	28
25-49	30	32	27
50-99	42	46	37
100-249	53	57	49
250-499	62	66	57
500-999	62	66	58
1,000 or more	73	76	70
Total ¹	50	51	48

¹ Total includes workers not responding or for whom firm size is unknown, not shown separately.

Source: U.S. Department of Labor, 1994, table B9.

TABLE 13-7.—COVERAGE OF WAGE AND SALARY WORKERS UNDER EMPLOYER-SPONSORED PENSION OR RETIREMENT PLAN, BY PRIVATE OR PUBLIC SECTOR

Sector	Percent covered		
	Total	Full time	Part time
All wage and salary workers	49	56	15
Men	51	56	9
Women	46	56	17
Private sector	43	50	12
Men	46	51	8
Women	39	48	15
Public sector	77	85	30
Men	80	86	22
Women	74	84	33

Source: U.S. Department of Labor, 1994, table B1.

The decline in coverage in the 1980s was concentrated among younger men. The coverage rate among older men has fallen less dramatically, and among women it has risen at some ages and fallen at others.

The decline in pension coverage has occurred at the same time that employers have been shifting from defined benefit plans. Defined benefit plans provided basic plan coverage for 87 percent of private wage and salary workers in 1975 (Turner & Beller, 1989, pp. 65 & 357). This proportion dropped to 83 percent by 1980 and to 71 percent by 1985. This shifting composition has largely been the result of rapid growth in primary defined contribution plans. Employee stock ownership plans and 401(k) plans have been among the most rapidly growing defined contribution plans.

INDIVIDUAL RETIREMENT PLANS

LEGISLATIVE HISTORY

ERISA added section 219 to the Internal Revenue Code, providing a tax deduction for certain contributions to individual retirement arrangements (IRAs) and permitting the deferral of tax on amounts held in such arrangements until withdrawal. Active participants in employer plans were not permitted to make deductible IRA contributions.

The Economic Recovery Tax Act of 1981 expanded eligibility to individuals who were active participants and increased the amount of the permitted deduction. The Tax Reform Act of 1986 limited the full IRA deduction to individuals with income below certain levels and to individuals who are not active participants in employer plans. Individuals who are not entitled to the full IRA deduction may make nondeductible contributions to an IRA. The Small Business Job Protection Act of 1996 increased contributions that can be made to the IRA of a nonworking spouse. The Health Insurance Portability and Accountability Act provided that the early withdrawal tax does not apply to withdrawals from IRAs: (1) for medical expenses that would be deductible (i.e., to the extent that total medical expenses exceed 7.5 percent of adjusted gross income); and (2) for health insurance expenses of unemployed individuals.

The Taxpayer Relief Act of 1997, effective for years beginning after December 31, 1997, made the following changes to the IRA provisions: (1) the income limits on deductible IRA contributions that apply to active participants in an employer-sponsored retirement plan were increased; (2) the nonworking spouse of an active participant in an employer-sponsored retirement plan may make a deductible contribution of up to \$2,000 to an IRA; (3) a new tax-free nondeductible IRA, the Roth IRA, was added; and (4) the 10-percent early withdrawal tax was waived for distributions from IRAs for education and first-time home buyer expenses.

EXPLANATION OF PROVISION

Deductible IRAs

An individual who is an active participant in an employer-sponsored retirement plan may deduct annual IRA contributions up to the lesser of \$2,000 or 100 percent of compensation if the individual's adjusted gross income (AGI) does not exceed certain limits.

The full \$2,000 IRA deduction limit is phased out for married individuals over the following levels of AGI: for 1998, \$50,000–\$60,000; for 1999, \$51,000–\$61,000; for 2000, \$52,000–\$62,000; for 2001, \$53,000–\$63,000; for 2002, \$54,000–\$64,000; for 2003, \$60,000–\$70,000; for 2004, \$65,000–\$75,000; for 2005, \$70,000–\$80,000; for 2006, \$75,000–\$85,000; and for 2007 and thereafter, \$80,000–\$100,000. The phase-out range for married individuals filing separate returns is \$0–\$10,000. A couple is not treated as married if the spouses file separate returns and do not live together at any time during the year. The phase-out range for single individuals is: for 1998, \$30,000–\$40,000; for 1999, \$31,000–\$41,000; for 2000, \$32,000–\$42,000; for 2001, \$33,000–\$43,000; for 2002,

\$34,000–\$44,000; for 2003, \$40,000–\$50,000; for 2004, \$45,000–\$55,000; for 2005 and thereafter, \$50,000–\$60,000.

For years beginning after 1997, an individual who is not an active participant, but whose spouse is, may make a full \$2,000 deductible IRA contribution if the AGI for the couple does not exceed \$150,000. The deduction limit is phased out for AGI between \$150,000 and \$160,000. An individual who is not an active participant in an employer-sponsored retirement plan may deduct IRA contributions up to the limits described above without limitation based on income.

The investment income of IRA accounts is not taxed until withdrawn. Withdrawn amounts attributable to deductible contributions and all earnings are includable in income. A 10-percent additional income tax is levied unless the withdrawal: (1) is made after the IRA owner attains age 59½ or dies; (2) is made on account of the disability of the IRA owner; (3) is one of a series of substantially equal periodic payments made not less frequently than annually over the life or life expectancy of the IRA owner (or the IRA owner and his or her beneficiary); or (4) is made to pay medical expenses in excess of 7.5 percent of AGI or for insurance premiums for unemployed individuals; or (5) is made after 1997 for first-time home buyer expenses (subject to a \$10,000 lifetime cap) or for qualified higher education expenses.

Roth IRAs

For years beginning after December 31, 1997, an individual may make nondeductible contributions up to the lesser of \$2,000 or 100 percent of compensation to a Roth IRA if the individual's AGI does not exceed \$95,000 for an unmarried individual, or \$150,000 for a married couple filing a joint return. The maximum contribution is phased out between AGI ranges of \$95,000–\$110,000 for unmarried individuals and of \$150,000–\$160,000 for married individuals filing a joint return. No more than \$2,000 of contributions can be made to all an individual's IRAs for a taxable year.

Qualified distributions from a Roth IRA are not includable in income. Qualified distributions are distributions: (1) made after the 5-year taxable period beginning with the first taxable year for which a contribution is made, and (2) which are made on or after the date the individual attains age 59½, are made to a beneficiary on or after the death of the individual, are attributable to the individual's being disabled, or are for a qualified special purpose distribution. A qualified special purpose distribution is a distribution for first-time home buyer expenses, as described above. Distributions that are not qualified distributions are includable in income, to the extent earnings are included in the distribution, and are subject to the 10-percent tax on early withdrawal, unless an exception applies, as described above for deductible IRAs.

Taxpayers with AGI of less than \$100,000 may convert an IRA to a Roth IRA at any time. If the conversion is made before January 1, 1999, the amounts that would have been includable in income had the amounts converted been withdrawn are includable in income ratably over 4 years. The 10-percent tax on early withdrawals does not apply to conversions of IRAs to Roth IRAs.

Nondeductible IRAs

An individual may make nondeductible contributions to an IRA to the extent the individual does not or cannot make deductible contributions to an IRA or contributions to a Roth IRA. Earnings on contributions to a nondeductible IRA accumulate tax free, and are includable in income when withdrawn. The 10-percent early withdrawal tax applies to such earnings, subject to the exceptions for deductible and Roth IRAs as described above.

EFFECT OF PROVISION

Use of IRAs expanded significantly when eligibility was expanded in 1982 to all persons with earnings and contracted correspondingly in 1987 when deductibility was restricted for higher income taxpayers who were covered by an employer-provided pension. The number of taxpayers claiming a deductible IRA contribution jumped from 3.4 million in 1981 to 12.0 million in 1982 and to 15.5 million in 1986. In 1987, only 7.3 million taxpayers reported deductible contributions. Since then, the number has continued to fall (see table 13–8).

TABLE 13–8.—USE OF DEDUCTIBLE IRAs, 1980–95

Year	Number of tax returns deducting IRA contributions (millions)	Total IRA deductions (billions)
1980	2.6	\$3.4
1981	3.4	4.8
1982	12.0	28.3
1983	13.6	32.1
1984	15.2	35.4
1985	16.2	38.2
1986	15.5	37.8
1987	7.3	14.1
1988	6.4	11.9
1989	5.8	10.8
1990	5.2	9.9
1991	4.7	9.0
1992	4.5	8.7
1993	4.4	8.5
1994	4.3	8.4
1995	4.3	8.3

Source: Internal Revenue Service, Statistics of Income, various years.

Upper-income taxpayers facing higher marginal tax rates receive more benefit per dollar of IRA deduction than do low-income taxpayers facing lower marginal tax rates. When IRAs were available to all workers, the percentage of taxpayers contributing to an IRA was substantially higher among taxpayers with higher income. For example, in 1985, 13.6 percent of taxpayers with AGI between \$10,000 and \$30,000 contributed to an IRA compared with 74.1 percent of taxpayers with AGI between \$75,000 and \$100,000.

The decline in IRA use between 1985 and 1990 among those with AGI between \$10,000 and \$30,000 appears to be larger than the reduction required by the change in law since the restrictions on deductible contributions apply only to a small fraction of taxpayers with AGI below \$30,000.

Eligibility percentages and the real value of the IRA contribution limits decline over time because present law does not index the contribution limits or the income eligibility limits for inflation. For example, the real value of a \$2,000 contribution has declined more than 30 percent since 1986 because of inflation.

Congress established IRAs to allow workers not covered by employer pension plans to have tax-advantaged retirement saving. Nonetheless, since 1981 IRA participation rates have been higher among those covered by an employer-provided pension plan than those without one, and many of those who are not covered by a pension plan do not contribute to an IRA. In 1987, 10 percent of full-time private-sector earners without pension coverage contributed to an IRA, while 15 percent of those with coverage contributed (Woods, 1989, p. 9).

EXCLUSION OF SOCIAL SECURITY AND RAILROAD RETIREMENT BENEFITS

LEGISLATIVE HISTORY

The exclusion from gross income for Social Security benefits was not initially established by statute. Prior to the Social Security Amendments of 1983, the exclusion was based on a series of administrative rulings issued by the Internal Revenue Service in 1938 and 1941.³

Under the Social Security Amendments of 1983, a portion of the Social Security benefits paid to higher income taxpayers is included in gross income. In 1993, the Omnibus Budget Reconciliation Act increased the amount of benefits subject to tax and increased the rate of tax for some benefit recipients.

The exclusion from gross income of benefits paid under the Railroad Retirement System was enacted in the Railroad Retirement Act of 1935. A portion of the benefits payable under the Railroad Retirement System (generally, tier 1 benefits) is equivalent to Social Security benefits. The tax treatment of tier 1 railroad retirement benefits was modified in the Social Security Amendments of 1983 to conform to the tax treatment of Social Security benefits. Other railroad retirement benefits are taxable in the same manner as employer-provided retirement benefits. The Consolidated Omnibus Budget Reconciliation Act of 1985 provided that tier 1 benefits are taxable in the same manner as Social Security benefits only to the extent that Social Security benefits otherwise would be payable. Other tier 1 benefits are taxable in the same manner as all other railroad retirement benefits (for further details, see section 5).

³See Internal Revenue Service, *Internal Revenue Bulletin*, 1938-1, Income Tax Unit 3154, p. 114; 1938-2, Income Tax Unit 3229, p. 136; and 1941-1, Income Tax Unit 3447, p. 191.

EXPLANATION OF PROVISION

For taxpayers whose modified adjusted gross income exceeds certain limits, a portion of Social Security and tier 1 railroad retirement benefits is included in taxable income. Modified adjusted gross income is adjusted gross income plus interest on tax-exempt bonds plus 50 percent of Social Security and tier 1 railroad retirement benefits. A two-tier structure applies. The base tier is \$25,000 for unmarried individuals and \$32,000 for married couples filing joint returns, and zero for married persons filing separate returns who do not live apart at all times during the taxable year. The amount of benefits includable in income is the lesser of 50 percent of the Social Security and tier 1 railroad retirement benefits or 50 percent of the excess of the taxpayer's combined income over the base amount.

The second tier applies to taxpayers with modified adjusted gross income of at least \$34,000 (unmarried taxpayers) or \$44,000 (married taxpayers filing joint returns). For these taxpayers, the amount of benefits includable in gross income is the lesser of 85 percent of Social Security benefits or the sum of 85 percent of the amount by which modified adjusted gross income exceeds the second-tier thresholds, and the smaller of the amount included under prior law or \$4,500 (unmarried taxpayers) or \$6,000 (married taxpayers filing jointly). The portion of tier 1 railroad retirement benefits potentially includable in taxable income under the above formula is the amount of benefits the taxpayer would have received if covered under Social Security. Pursuant to section 72(r) of the Internal Revenue Code of 1986, all other benefits payable under the Railroad Retirement System are includable in income when received to the extent they exceed employee contributions.

EFFECT OF PROVISION

About 23 percent of all Social Security recipients pay taxes on their benefits. This percentage is likely to increase over time because the thresholds are not adjusted annually for past inflation or other factors.

**EXCLUSION OF EMPLOYER CONTRIBUTION FOR
MEDICAL INSURANCE PREMIUMS AND MEDICAL CARE**

LEGISLATIVE HISTORY

In 1943, the Internal Revenue Service (IRS) ruled that employer contributions to group health insurance policies were not taxable to the employee. Employer contributions to individual health insurance policies, however, were declared to be taxable income in an IRS revenue ruling in 1953.

Section 106 of the Internal Revenue Code, enacted in 1954, reversed the 1953 IRS ruling. As a result, employer contributions to all accident or health plans generally are excluded from gross income and therefore are not subject to tax. Under section 105 of the Internal Revenue Code, benefits received under an employer's accident or health plan generally are not included in the employee's income.

In the Revenue Act of 1978, Congress added section 105(h) to tax the benefits payable to highly compensated employees under a self-insured medical reimbursement plan if the plan discriminated in favor of highly compensated employees.

EXPLANATION OF PROVISION

Gross income of an employee generally excludes employer-provided coverage under an accident or health plan. The exclusion applies to coverage provided to former employees, their spouses, or dependents. Amounts excluded include those received by an employee for personal injuries or sickness if the amounts are paid directly or indirectly to reimburse the employee for expenses incurred for medical care. However, this exclusion does not apply in the case of amounts paid to a highly compensated individual under a self-insured medical reimbursement plan if the plan violates the non-discrimination rules of section 105(h).

Present law permits employers to prefund medical benefits for retirees. Postretirement medical benefits may be prefunded by the employer in two basic ways: (1) through a separate account in a tax-qualified pension plan (sec. 401(h)); or (2) through a welfare benefit fund (secs. 419 and 419A). Generally, the amounts contributed are excluded from the income of the plan or participants. Although amounts held in a section 401(h) account are accorded tax-favored treatment similar to assets held in a pension trust, the benefits provided under a section 401(h) account are required to be incidental to the retirement benefits provided by the plan. Amounts contributed to welfare benefit funds are subject to certain deduction limitations (secs. 419 and 419A). In addition, the fund is subject to income tax relating to any set-aside to provide postretirement medical benefits.

EFFECT OF PROVISION

The exclusion for employer-provided health coverage provides an incentive for compensation to be furnished to the employee in the form of health coverage, rather than in cash subject to current taxation. For example, an employer designing a compensation package for an employee would be indifferent between paying the employee one dollar in cash and purchasing one dollar's worth of health insurance for the employee.⁴ On the other hand, because the employee is likely to pay Federal and State income taxes and payroll taxes on cash compensation and no tax on health insurance contributions made on his behalf, the employee would likely prefer that some compensation be in the form of health insurance. Employees subject to tax at the highest marginal tax rates have the greatest incentive to receive compensation in nontaxable forms.

The tax preference that the exclusion provides is substantial and has resulted in widespread access to health coverage. A majority of the population now receives health insurance as a consequence of their own employment or of a family member's employment. In 1996, for 58 percent of the population, employment-based health insurance was the primary source of health coverage, while 5 percent

⁴To the extent the employer bears a portion of the payroll tax, the employer may actually prefer to provide compensation through health insurance (which is not subject to payroll tax).

purchased insurance privately, 13 percent received Medicare benefits, and 9 percent received Medicaid benefits. According to a special analysis of data from the Current Population Survey conducted by the CBO, 15 percent of the population had no health insurance.

Health coverage through employer-based plans tends to be more prevalent in the finance, government, manufacturing, and mining sectors of the economy, among medium and large firms, for more highly paid workers, and among those over age 30 (see table 13-9).

MEDICAL SAVINGS ACCOUNTS

The Health Insurance Portability and Accountability Act of 1996 included provisions for medical savings accounts (MSAs), effective for years beginning after December 31, 1996. Within limits, contributions to an MSA are deductible if made by an eligible individual and are excludable from income and employment taxes if made by the employer (other than contributions made through a cafeteria plan). Earnings on amounts in an MSA are not currently taxable. Distributions from an MSA for medical expenses are not includable in gross income. Distributions from an MSA that are not for medical expenses are includable in gross income and are subject to an additional tax of 15 percent, unless the distribution is made after death, disability, or age 65.

Beginning in 1997, MSAs are available to employees covered under an employer-sponsored high deductible health plan of a small employer and to self-employed individuals covered under a high deductible health plan (regardless of the size of the entity for which the self-employed individual performs services). A small employer is defined as an employer with 50 or fewer employees.

In order to be eligible for an MSA contribution, an otherwise eligible individual must be covered under a high deductible health plan and no other health plan. A high deductible health plan is a plan with an annual deductible of at least \$1,500 and no more than \$2,250 in the case of individual coverage (and at least \$3,000 and no more than \$4,500 in the case of family coverage). The dollar limits are indexed for inflation. High deductible plans must also meet certain limits on out-of-pocket expenses.

The number of taxpayers benefiting annually from an MSA contribution is limited to a threshold level (generally, 750,000 taxpayers). If it is determined in a year that the threshold level has been exceeded (called a cutoff year), then, in general, for succeeding years during the 4-year pilot period 1997–2000, only those individuals who (1) made an MSA contribution or had an employer MSA contribution for the year or a preceding year (i.e., are active MSA participants) or (2) are employed by a participating employer, would be eligible for an MSA contribution. In determining whether the threshold for any year has been exceeded, MSAs of previously uninsured individuals are not taken into account.

After December 31, 2000, no new contributions may be made to MSAs except by or on behalf of an individual who previously had MSA contributions and employees who are employed by a participating employer. Self-employed individuals who made contributions to an MSA during the period 1997–2000 also may continue to make contributions after 2000.

TABLE 13-9.—PRIMARY SOURCE OF HEALTH INSURANCE FOR WORKERS UNDER AGE 65
BY DEMOGRAPHIC CATEGORY, MARCH 1996

Category	Number of workers (mil- lions)	Percentage distribution by source of insurance			
		Own or other em- ployer	Individ- ual policy	Public insur- ance ¹	No in- surance
Industry:					
Agriculture	3.0	45.4	15.5	3.6	35.5
Construction	8.0	61.2	6.8	2.0	29.9
Finance	7.8	83.6	5.0	1.4	10.1
Government	5.6	92.3	1.8	0.8	5.1
Manufacturing	20.4	82.9	2.2	1.6	13.3
Mining	0.6	81.8	3.1	2.0	13.1
Retail trade	18.0	63.3	5.4	4.7	26.7
Services:					
Professional	28.6	83.0	4.5	1.9	10.7
Other	13.9	61.7	7.4	4.1	26.8
Transportation	8.5	81.9	3.2	1.4	13.5
Wholesale trade	4.7	78.6	4.8	1.4	15.2
Wage rate ² :					
Below \$5.00	5.4	50.2	4.5	6.8	38.5
\$5.00–\$9.99	39.1	68.7	3.8	3.6	24.0
\$10.00–\$14.99	25.8	85.6	3.1	0.8	10.5
\$15.00 or more	29.6	92.9	1.8	0.1	5.2
Family income as percentage of poverty level:					
Under 100	8.9	25.6	5.0	20.1	49.2
100–199	19.4	52.6	5.9	5.9	35.6
200–299	22.3	72.3	5.5	1.9	20.3
300 or more	75.4	86.5	4.4	0.5	8.6
Firm size (number of employees):					
Fewer than 10	25.2	51.0	14.1	4.0	30.9
10–24	11.7	63.7	5.7	3.5	27.0
25–99	16.1	74.0	3.1	3.2	19.8
100–499	17.6	81.2	2.0	2.5	14.4
500–999	7.5	82.9	2.4	2.6	12.1
1,000 or more	48.0	85.8	1.8	2.4	9.9
Age (years):					
Under 30	31.1	62.9	3.9	5.7	27.5
30–39	37.5	75.4	4.1	2.8	17.7
40–49	33.3	80.0	4.9	1.8	13.2
50–64	24.1	80.4	7.0	1.2	11.3
All workers	126.0	74.5	4.9	3.0	17.7

¹Public insurance includes Medicaid, Medicare, and coverage provided by the Department of Veterans Affairs.

²Wage is the hourly wage for hourly employees and earnings per week divided by hours worked for nonhourly employees. The figures exclude individuals for whom an hourly wage could not be determined.

Source: Congressional Budget Office estimates based on the March 1994 Current Population Survey.

CAFETERIA PLANS

LEGISLATIVE HISTORY

Under present law, compensation generally is includable in gross income when received. An exception applies if an employee may choose between cash and certain employer-provided nontaxable benefits under a cafeteria plan.

Prior to 1978, ERISA provided that an employer contribution made before January 1, 1977 to a cafeteria plan in existence on June 27, 1974, had to be included in an employee's gross income only to the extent that the employee actually elected taxable benefits. If a plan did not exist on June 27, 1974, the employer contribution was to be included in income to the extent the employee could have elected taxable benefits. The Revenue Act of 1978 set up permanent rules for plans that offer an election between taxable and nontaxable benefits.

The Deficit Reduction Act of 1984 (Public Law 98-369) clarified the types of employer-provided benefits that could be provided through a cafeteria plan, added a 25-percent concentration test, and required annual reporting to the IRS by employers.

The Tax Reform Act of 1986 also modified the rules relating to cafeteria plans in several respects.

EXPLANATION OF PROVISION

A participant in a cafeteria plan (sec. 125) is not treated as having received taxable income solely because the participant had the opportunity to elect to receive cash or certain nontaxable benefits. In order to meet the requirements of section 125, the plan must be in writing, must include only employees (including former employees) as participants, and must satisfy certain nondiscrimination requirements.

In general, a nontaxable benefit may be provided through a cafeteria plan if the benefit is excludable from the participant's gross income by reason of a specific provision of the Code. These include employer-provided health coverage, group-term life insurance coverage, and benefits under dependent care assistance programs. A cafeteria plan may not provide qualified scholarships or tuition reduction, educational assistance, miscellaneous employer-provided fringe benefits, or deferred compensation except through a qualified cash or deferred arrangement.

If the plan discriminates in favor of highly compensated individuals regarding eligibility to participate, to make contributions, or to receive benefits under the plan, then the exclusion does not apply. For purposes of these nondiscrimination requirements, a highly compensated individual is an officer, a shareholder owning more than 5 percent of the employing firm, a highly compensated individual determined under the facts and circumstances of the case, or a spouse or dependent of the above individuals.

EFFECT OF PROVISION

The optimal compensation of employees (in a tax planning sense) would require that employers and employees arrive at the compensation package that provides the largest aftertax benefit to the employee at minimum aftertax cost to the employer (see Scholes & Wolfson, 1992, chapter 10). Both the potential taxation of compensation provided to employees and the deductibility of compensation provided by the employer would be considered. If only income taxes were considered, employers would be indifferent between the payment of \$1 in salary or wages and the payment of \$1 in fringe benefits to an employee, because both types of compensation are fully deductible. When the employer payments for FICA and FUTA taxes are considered, however, the employer might actually find it less costly to compensate an employee with a dollar's worth of fringe benefit not subject to FICA and FUTA taxes rather than a dollar of wage or salary payments that are subject to these taxes.

The employee, however, would prefer to be compensated in the form that provides the highest aftertax value. An additional dollar of salary or wage paid to the employee will be subject to tax. If a fringe benefit is excludable from the employee's income, the employee pays no tax on receipt of the benefit. Consequently, the employee receives greater compensation via the fringe benefit. This differential treatment of salary or wage payments and excludable fringe benefits implies that compensation packages designed to minimize the joint tax liability of employers and employees could include substantial amounts of excludable fringe benefits.

Employees may have different preferences about the allocation of their compensation. For example, an employee with no dependents may place little value on employer-provided life insurance. Cafeteria plans permit employees some discretion as to the provided benefits, and will tend to be preferred to benefit plans in which all employees of the firm receive the identical benefit package.

Cafeteria plans are a growing part of compensation plans, particularly for larger employers. The Bureau of Labor Statistics estimated that in 1995, 55 percent of employees at large- and medium-sized firms were eligible for some type of cafeteria plan. This figure has grown from an estimated 5 percent in 1986 (U.S. Bureau of Labor Statistics, 1993). Smaller firms generally do not offer cafeteria plans to their workers. For example, in 1994, only 19 percent of the workers in small, private establishments (nonfarm establishments with fewer than 100 employees) were eligible to participate in a cafeteria plan (U.S. Bureau of Labor Statistics, 1994). The lower figure for smaller firms reflects in part the less generous fringe benefit packages provided by smaller firms.

Like any income exclusion, the exclusion from gross income for cafeteria plan benefits can lead to disparities in the tax system. Employees with the same total compensation can have taxable incomes that are substantially different because of the form in which compensation is received. The exclusion for cafeteria plan benefits also may be used in some cases to avoid the 7.5 percent of AGI floor on deductible medical expenses. The use of cafeteria plans reduces the aftertax cost of health care to employees using these plans, which could cause these employees to purchase a larger

amount of health care services. On the other hand, cafeteria plans could encourage employers to increase the share of premiums, co-payments, and deductibles paid by employees, resulting in increased employee awareness of the costs of their health plans. This incentive could result in reduced health care costs.

HEALTH CARE CONTINUATION RULES

LEGISLATIVE HISTORY

The Consolidated Omnibus Budget Reconciliation Act of 1985 added sections 106(b), 162(i)(2), and 162(k) to the Internal Revenue Code under which certain group health plans are required to offer health coverage to certain employees and former employees, as well as to their spouses and dependents. Parallel requirements were added to title I of ERISA and the Public Health Services Act. If an employer failed to satisfy the health care continuation rules, the employer was denied a deduction for contributions to its group health plans and highly compensated employees were required to include in taxable income the employer-provided value of the coverage received under such plans.

The Technical and Miscellaneous Revenue Act of 1988 made several changes to the health care continuation rules. Sections 106(b), 162(i)(2), and 162(k) were repealed and replaced by section 4980B. Section 4980B imposes an excise tax on the employer or other responsible party who fails to satisfy the rules instead of denying deductions and the exclusion. The Health Insurance Portability and Accountability Act of 1996 made some changes to the health care continuation rules in cases of disability.

EXPLANATION OF PROVISION

The health care continuation rules in section 4980B require that an employer provide qualified beneficiaries with the opportunity to participate for a specified period in the employer's health plan after that participation otherwise would have terminated. If the employee elects such continuation coverage, the employee may be required to pay for the coverage. The amount the employee can be required to pay is subject to certain limits.

The qualifying events that may trigger rights to continuation coverage are: (1) the death of the employee; (2) the voluntary or involuntary termination of the employee's employment (other than by reason of gross misconduct); (3) a reduction of the employee's hours; (4) the divorce or legal separation of the employee; (5) the employee becoming entitled to benefits under Medicare; and (6) a dependent child of the employee ceasing to be a dependent under the employer's plan. The maximum period of continuation coverage is 36 months, except in the case of termination of employment or reduction of hours for which the maximum period is 18 months. The 18-month period is extended to 29 months in certain cases involving the disability of the qualified beneficiary. Certain events, such as the failure by the qualified beneficiary to pay the required premium, may trigger an earlier cessation of the continuation coverage.

A beneficiary has a prescribed period of time during which to elect continuation coverage after the employee receives notice from the plan administrator of the right to continuation coverage.

GROUP HEALTH PLAN REQUIREMENTS

The Health Insurance Portability and Accountability Act of 1996 imposes certain requirements regarding health coverage portability through limitations on preexisting condition exclusions, prohibitions on excluding individuals from coverage based on health status, and guaranteed renewability of health insurance coverage. An excise tax is imposed with respect to failures of a group health plan to comply with the requirements. The tax is usually imposed on the employer sponsoring the plan. The amount of the tax is generally equal to \$100 per day for each day during which the failure occurs until the failure is corrected. The maximum tax that can be imposed is the lesser of 10 percent of the employer's payments during the taxable year in which the failure occurred under group health plans or \$500,000. The Secretary of the Treasury may waive all or part of the tax to the extent that payment of the tax would be excessive relative to the failure involved (see discussion of health care continuation rules).

TAX BENEFITS FOR ACCELERATED DEATH BENEFITS AND LONG-TERM CARE INSURANCE

LEGISLATIVE HISTORY

Accelerated death benefits

If a contract meets the definition of a life insurance contract, gross income does not include insurance proceeds that are paid pursuant to the contract by reason of the death of the insured (sec. 101(a)). In addition, the undistributed investment income (inside buildup) earned on premiums credited under the contract is not subject to current taxation to the owner of the contract. The exclusion under section 101 applies regardless of whether the death benefits are paid as a lump sum or otherwise.

If a contract fails to be treated as a life insurance contract under section 7702(a), inside buildup on the contract is generally subject to tax (sec. 7702(g)).

To qualify as a life insurance contract for Federal income tax purposes, a contract must be a life insurance contract under the applicable State or foreign law and must satisfy either of two alternative tests: (1) a cash value accumulation test, or (2) a test consisting of a guideline premium requirement and a cash value corridor requirement (sec. 7702(a)). A contract satisfies the cash value accumulation test if the cash surrender value of the contract may not at any time exceed the net single premium that would have to be paid at such time to fund future benefits under the contract. A contract satisfies the guideline premium and cash value corridor tests if the premiums paid under the contract do not at any time exceed the greater of the guideline single premium or the sum of the guideline level premiums, and if the death benefit under the contract is not less than a varying statutory percentage of the cash surrender value of the contract.

Long-term care insurance

Prior to the Health Insurance Portability and Accountability Act of 1996, tax law generally did not provide explicit rules relating to the tax treatment of long-term care insurance contracts or long-term care services. Thus, the treatment of long-term care contracts and services was unclear. Prior and present law provide rules relating to medical expenses and accident or health insurance.

Amounts received by a taxpayer under accident or health insurance for personal injuries or sickness generally are excluded from gross income to the extent that the amounts received are not attributable to medical expenses that were allowed as a deduction for a prior taxable year (sec. 104).

EXPLANATION OF PROVISION

Accelerated death benefits

The Health Insurance Portability and Accountability Act of 1996 provides an exclusion from gross income as an amount paid by reason of the death of an insured for amounts received under a life insurance contract and for amounts received for the sale or assignment of a life insurance contract to a qualified viatical settlement provider, provided that the insured under the life insurance contract is either terminally ill or chronically ill.

The exclusion does not apply in the case of an amount paid to any taxpayer other than the insured, if such taxpayer has an insurable interest by reason of the insured being a director, officer, or employee of the taxpayer, or by reason of the insured being financially interested in any trade or business carried on by the taxpayer.

A terminally ill individual is defined as one who has been certified by a physician as having an illness or physical condition that reasonably can be expected to result in death within 24 months of the date of certification.

A chronically ill individual has the same meaning as provided under the long-term care rules (see below). In the case of a chronically ill individual, the exclusion with respect to amounts paid under a life insurance contract and amounts paid in a sale or assignment to a viatical settlement provider applies if the payment received is for costs incurred by the payee (not compensated by insurance or otherwise) for qualified long-term care services for the insured person for the period, and two other requirements (similar to requirements applicable to long-term care insurance contracts) are met.

The first requirement is that under the terms of the contract giving rise to the payment, the payment is not a payment or reimbursement of expenses reimbursable under Medicare (except where Medicare is a secondary payor under the arrangement, or the arrangement provides for per diem or other periodic payments without regard to expenses for qualified long-term care services). No provision of law shall be construed or applied so as to prohibit the offering of such a contract giving rise to such a payment on the basis that the contract coordinates its payments with those provided under Medicare. The second requirement is that the arrangement complies with the consumer protection provisions applicable

to long-term care insurance contracts and issuers that are specified in Treasury regulations.

Long-term care insurance

Exclusion of long-term care insurance proceeds.—The Health Insurance Portability and Accountability Act of 1996 provides that a long-term care insurance contract generally is treated as an accident and health insurance contract. Amounts (other than policyholder dividends or premium refunds) received under a long-term care insurance contract generally are excludable as amounts received for personal injuries and sickness, subject to a dollar cap on aggregate payments under per diem contracts. A reporting requirement applies to payors of excludable amounts.

The amount of the dollar cap on aggregate payments under per diem contracts with respect to any one chronically ill individual (who is not also terminally ill) is \$175 per day (\$63,875 annually) as indexed, reduced by the amount of reimbursements and payments received by anyone for the cost of qualified long-term care services for the chronically ill individual. If more than one payee receives payments with respect to any one chronically ill individual, then everyone receiving periodic payments with respect to the same insured is treated as one person for purposes of the dollar cap. The amount of the dollar cap is used first by the chronically ill person, and any remaining amount is to be allocated in accordance with Treasury regulations. If payments under such contracts exceed the dollar cap, then the excess is excludable only to the extent of actual costs (in excess of the dollar cap) incurred for long-term care services. Amounts in excess of the dollar cap, with respect to which no actual costs were incurred for long-term care services, are fully includable in income without regard to rules relating to return of basis under section 72. A grandfather rule applies to any per diem-type contract issued to a policyholder on or before July 31, 1996.

Exclusion for employer-provided long-term care coverage.—A plan of an employer providing coverage under a long-term care insurance contract generally is treated as an accident and health plan. Thus, employer-provided long-term care coverage is generally excludable from income and wages and deductible by the employer. Employer-provided coverage under a long-term care insurance contract is not, however, excludable by an employee if provided through a cafeteria plan; similarly, expenses for long-term care services cannot be reimbursed under a flexible spending arrangement.

Definition of long-term care insurance contract.—A long-term care insurance contract is defined as any insurance contract that provides only coverage of qualified long-term care services and that meets other requirements. The other requirements are that: (1) the contract is guaranteed renewable; (2) the contract does not provide for a cash surrender value or other money that can be paid, assigned, pledged or borrowed; (3) refunds (other than refunds on the death of the insured or complete surrender or cancellation of the contract) and dividends under the contract may be used only to reduce future premiums or increase future benefits; and (4) the contract generally does not pay or reimburse expenses reimbursable

under Medicare (except where Medicare is a secondary payor, or the contract makes per diem or other periodic payments without regard to expenses).

A contract does not fail to be treated as a long-term care insurance contract solely because it provides for payments on a per diem or other periodic basis without regard to expenses incurred during the period.

Medicare duplication rules.—No provision of law may be applied to prohibit the offering of a long-term care insurance contract on the basis that the contract coordinates its benefits with those provided under Medicare.

Definition of qualified long-term care services.—Qualified long-term care services means necessary diagnostic, preventive, therapeutic, curing, treating, mitigating and rehabilitative services, and maintenance or personal care services that are required by a chronically ill individual and that are provided pursuant to a plan of care prescribed by a licensed health care practitioner.

Chronically ill individual.—A chronically ill individual is one who has been certified within the previous 12 months by a licensed health care practitioner as: (1) being unable to perform (without substantial assistance) at least two activities of daily living for at least 90 days due to a loss of functional capacity; (2) having a similar level of disability as determined by the Secretary of the Treasury in consultation with the Secretary of Health and Human Services; or (3) requiring substantial supervision to protect such individual from threats to health and safety due to severe cognitive impairment. Activities of daily living are eating, toileting, transferring, bathing, dressing and continence. For purposes of determining whether an individual is chronically ill, the number of activities of daily living that are taken into account under the long-term care insurance contract may not be less than five.

Expenses for long-term care services treated as medical expenses.—Unreimbursed expenses for qualified long-term care services provided to the taxpayer or the taxpayer's spouse or dependents are treated as medical expenses for purposes of the itemized deduction for medical expenses (subject to the present-law floor of 7.5 percent of adjusted gross income). For this purpose, amounts received under a long-term care insurance contract (regardless of whether the contract reimburses expenses or pays benefits on a per diem or other periodic basis) are treated as reimbursement for expenses actually incurred for medical care.

For purposes of the deduction for medical expenses, qualified long-term care services do not include services provided to an individual by a relative or spouse (directly, or through a partnership, corporation, or other entity), unless the relative is a licensed professional with respect to such services, or by a related corporation (within the meaning of Code section 267(b) or 707(b)).

Long-term care insurance premiums treated as medical expenses.—Long-term care insurance premiums that do not exceed specified dollar limits are treated as medical expenses for purposes of the itemized deduction for medical expenses.

Consumer protection provisions.—Certain consumer protection provisions apply with respect to the terms of a long-term care insurance contract, for purposes of determining whether the contract

is a qualified long-term care insurance contract. In addition, certain consumer protection provisions apply to issuers of long-term care insurance contracts.

DEDUCTION FOR HEALTH INSURANCE EXPENSES OF SELF-EMPLOYED INDIVIDUALS

Self-employed individuals may currently deduct 40 percent of their health insurance expenses for themselves and their spouses and dependents. The deduction also applies to certain long-term care premiums treated as medical expenses. Under the Taxpayer Relief Act of 1997, the deduction for health insurance of self-employed individuals will increase as follows: the deduction will be 45 percent in 1998 and 1999; 50 percent in 2000 and 2001; 60 percent in 2002; 80 percent in 2003–5; 90 percent in 2006; and 100 percent in 2007 and thereafter.

EXCLUSION OF MEDICARE BENEFITS

LEGISLATIVE HISTORY

The exclusion from income of Medicare benefits has never been expressly established by statute. A 1970 IRS ruling, Rev. Rul. 70–341, 1970–2 C.B. 31, provided that the benefits under part A of Medicare are not includable in gross income because they are disbursements made to further the social welfare objectives of the Federal Government. The Internal Revenue Service relied on a similar ruling, Rev. Rul. 70–217, 1970–1 C.B. 13, with respect to the excludability of Social Security disability insurance benefits in reaching this conclusion. (For background on the exclusion of Social Security benefits, see above section on pension contributions.) Rev. Rul. 70–341 also held that benefits under part B of Medicare are excludable as amounts received through accident and health insurance (though the subsidized portion of part B also may be excluded under the same theory applicable to the exclusion of part A benefits).

EXPLANATION OF PROVISION

Benefits under part A and part B of Medicare are excludable from the gross income of the recipient. In general, part A pays for certain inpatient hospital care, skilled nursing facility care, home health care, and hospice care for eligible individuals (generally the elderly and the disabled). Part B covers certain services of a physician and other medical services for elderly or disabled individuals who elect to pay the required premium.

DEDUCTIBILITY OF MEDICAL EXPENSES

LEGISLATIVE HISTORY

An itemized deduction for unreimbursed medical expenses above a specified floor has been allowed since 1942. From 1954 through 1982, the floor under the medical expense deduction was 3 percent of the taxpayer's adjusted gross income (AGI); a separate floor of 1 percent of AGI applied to expenditures for medicine and drugs.

In the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the floor was increased to 5 percent of AGI (effective for 1983 and thereafter) and was applied to the total of all eligible medical expenses, including prescription drugs and insulin. TEFRA made nonprescription drugs ineligible for the deduction and eliminated the separate floor for drug costs.

The Tax Reform Act of 1986 increased the floor under the medical expense deduction to 7.5 percent of AGI, beginning in 1987.

EXPLANATION OF PROVISION

Individuals who itemize deductions may deduct amounts they pay during the taxable year, if not reimbursed by insurance or otherwise, for medical care of the taxpayer and of the taxpayer's spouse and dependents, to the extent that the total of such expenses exceeds 7.5 percent of AGI (sec. 213).

Medical care expenses eligible include: (1) health insurance (including aftertax employee contributions to employer health plans); (2) diagnosis, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body; (3) transportation primarily for and essential to medical care; (4) lodging away from home primarily for and essential to medical care, up to \$50 per night; and (5) prescription drugs and insulin.

Expenses paid for the general improvement of health, such as fees for exercise programs, are not eligible for the deduction unless prescribed by a physician to treat a specific illness. A deduction is not allowed for cosmetic surgery or similar procedures that do not meaningfully promote the proper function of the body or treat disease. However, such expenses are deductible if the cosmetic procedure is necessary to correct a deformity arising from a congenital abnormality, an injury resulting from an accident, or disfiguring disease.

Medical expenses are not subject to the general limitation on itemized deductions applicable to taxpayers with adjusted gross incomes above a certain limit (\$121,200 for 1997 and adjusted annually for inflation).

EFFECT OF PROVISION

The Tax Code allows taxpayers to claim an itemized deduction if unreimbursed medical expenses absorb a substantial portion of income and thus adversely affect the taxpayer's ability to pay taxes. In order to limit the deduction to extraordinary expenses, medical expenses are deductible only to the extent that they exceed 7.5 percent of the taxpayer's AGI.

Table 13-10 shows the effect on medical expense deductions of the increases in the floor on medical deductions. In the absence of those increases, one would have expected the number of taxpayers claiming the deduction to have increased because of inflation of medical costs. However, increasing the floor should reduce the number of taxpayers claiming the deduction because many taxpayers with relatively modest expenses no longer qualify. The average deduction in excess of the 7.5 percent of AGI floor has increased substantially, from \$769 in 1980 to \$5,039 in 1995. Both increases in the floor (to 5 percent in 1983 and to 7.5 percent in

1987) substantially reduced the number of taxpayers claiming deductions.

Taxpayers in higher tax rate brackets receive more of a benefit from each dollar of deductible medical expense than do taxpayers in lower tax rate brackets. However, because the floor automatically rises with a taxpayer's income, higher income taxpayers are able to deduct a smaller amount (if any) of medical expenses above their floor than are low-income taxpayers incurring the same aggregate amount of medical expenses.

TABLE 13-10.—TAX RETURNS CLAIMING DEDUCTIBLE MEDICAL AND DENTAL EXPENSES, 1980-95

Year	Total number of returns filed (in millions)	Returns claiming medical and dental expenses in excess of the AGI floor		
		Number of returns (in millions)	Expenses in excess of the AGI floor (in billions)	Average amount over the floor
1980	93.9	19.5	\$15.0	\$769
1981	95.4	21.4	17.9	836
1982	95.3	22.0	21.7	986
1983	96.3	9.7	18.1	1,859
1984	99.4	10.7	21.5	2,009
1985	101.7	10.8	22.9	2,127
1986	103.0	10.5	25.1	2,382
1987	107.0	5.4	17.2	3,202
1988	110.1	4.8	18.0	3,741
1989	112.1	5.1	20.9	4,079
1990	113.7	5.1	21.5	4,215
1991	114.7	5.3	23.7	4,444
1992	113.6	5.5	25.7	4,675
1993	114.6	5.5	26.5	4,829
1994	115.9	5.2	26.4	5,044
1995	118.2	5.4	27.0	5,039

Source: Internal Revenue Service.

In 1995, approximately 5,351,000 taxpayers claimed itemized medical expenses in excess of the medical deductions floor (7.5 percent of adjusted gross income). Of that number, 79 percent had incomes of less than \$50,000 (see table 13-11). However, taxpayers with incomes over \$50,000 received far more than half of the total tax savings attributable to medical expense deductions.

TABLE 13-11.—DISTRIBUTION OF ITEMIZED DEDUCTIONS FOR MEDICAL EXPENSES,
1995

Income class (thousands) ¹	Average deduction	Returns (thousands)	Total amount (billions) ²
0-\$10	\$5,819	471	\$2.7
\$10-\$20	5,736	1,140	6.5
\$20-\$30	3,799	1,035	3.9
\$30-\$40	4,015	888	3.6
\$40-\$50	4,086	679	2.8
\$50-\$75	4,992	790	3.9
\$75-\$100	7,146	220	1.6
\$100-\$200	12,038	114	1.4
\$200 and over	38,442	13	0.5
Total	5,039	5,351	27.0

¹The income concept is defined in the introduction to this chapter.

²Amounts in excess of the floor on itemized medical deductions (7.5 percent of adjusted gross income).

Source: Internal Revenue Service.

EARNED INCOME CREDIT

LEGISLATIVE HISTORY

The earned income credit (EIC Code sec. 32), enacted in 1975, generally equals a specified percentage of wages up to a maximum dollar amount. The maximum amount applies over a certain income range and then diminishes to zero over a specified phaseout range. The income ranges and percentages have been revised several times since original enactment, expanding the credit (see table 13-12).

In 1987, the credit was indexed for inflation. In 1990 and again in 1993, Congress enacted substantial expansions of the credit. Auxiliary credits were added for very young children and for health insurance premiums paid on behalf of a qualifying child in 1990. These were repealed in 1993. Also in 1993, eligibility for the credit was expanded to include childless workers. The Personal Responsibility and Work Opportunity Reconciliation Act of 1996 incorporated new rules relating to taxpayer identification numbers and the modified AGI phaseout of the credit in addition to amending the credit's unearned income test (described below). The Taxpayer Relief Act of 1997 also included provisions to improve compliance. The provisions: (1) deny the EIC for 10 years to taxpayers who fraudulently claimed the EIC, 2 years for EIC claims which are a result of reckless or intentional disregard of rules or regulations); (2) require EIC recertification for a taxpayer who is denied the EIC; (3) imposes due diligence requirements on paid preparers of returns involving the EIC; (4) requires information sharing between the Treasury Department and State and local governments regarding child support orders; and (5) allows expanded use of Social Security Administration records to enforce the tax laws, including the EIC. The Balanced Budget Act of 1997 also increased the IRS authorization to improve enforcement of the EIC.

TABLE 13-12.—EARNED INCOME CREDIT PARAMETERS, 1975-97

[Dollar amounts unadjusted for inflation]

Calendar year	Credit rate (percent)	Minimum income for maxi- mum credit	Maxi- mum credit	Phaseout rate (percent)	Phaseout range	
					Begin- ning income	Ending income
1975-78	10.00	\$4,000	\$400	10.00	\$4,000	\$8,000
1979-84	10.00	5,000	500	12.50	6,000	10,000
1985-86	14.00	5,000	550	12.22	6,500	11,000
1987	14.00	6,080	851	10.00	6,920	15,432
1988	14.00	6,240	874	10.00	9,840	18,576
1989	14.00	6,500	910	10.00	10,240	19,340
1990	14.00	6,810	953	10.00	10,730	20,264
1991:						
One child	16.70	7,140	1,192	11.93	11,250	21,250
Two children	17.30	7,140	1,235	12.36	11,250	21,250
1992:						
One child	17.60	7,520	1,324	12.57	11,840	22,370
Two children	18.40	7,520	1,384	13.14	11,840	22,370
1993:						
One child	18.50	7,750	1,434	13.21	12,200	23,050
Two children	19.50	7,750	1,511	13.93	12,200	23,050
1994:						
No children	7.65	4,000	306	7.65	5,000	9,000
One child	26.30	7,750	2,038	15.98	11,000	23,755
Two children	30.00	8,425	2,528	17.68	11,000	25,296
1995:						
No children	7.65	4,100	314	7.65	5,130	9,230
One child	34.00	6,160	2,094	15.98	11,290	24,396
Two children	36.00	8,640	3,110	20.22	11,290	26,673
1996:						
No children	7.65	4,220	323	7.65	5,280	9,500
One child	34.00	6,330	2,152	15.98	11,610	25,078
Two children	40.00	8,890	3,556	21.06	11,610	28,495
1997:						
No children	7.65	4,340	332	7.65	5,430	9,770
One child	34.00	6,500	2,210	15.98	11,930	25,750
Two children	40.00	9,140	3,656	21.06	11,930	29,290

Source: Joint Committee on Taxation.

EXPLANATION OF PROVISION

The EIC is available to low-income working taxpayers. Three separate schedules apply.

Taxpayers with one qualifying child may claim a credit in 1997 of 34 percent of their earnings up to \$6,500, resulting in a maximum credit of \$2,210. The maximum credit is available for those with earnings between \$6,500 and \$11,930. At \$11,930 of earnings the credit begins to phase down at a rate of 15.98 percent of earnings above \$11,930. The credit is phased down to 0 at \$25,750 of earnings.

Taxpayers with more than one qualifying child may claim a credit in 1997 of 40 percent of earnings up to \$9,140, resulting in a maximum credit of \$3,656. The maximum credit is available for those with earnings between \$9,140 and \$11,930. At \$11,930 of earnings the credit begins to phase down at a rate of 21.06 percent of earnings above \$11,930. The credit is phased down to \$0 at \$29,290 of earnings.

Taxpayers with no qualifying children may claim a credit if they are over age 24 and below age 65. The credit is 7.65 percent of earnings up to \$4,340, resulting in a maximum credit of \$332. The maximum is available for those with incomes between \$4,340 and \$5,430. At \$5,430 of earnings, the credit begins to phase down at a rate of 7.65 percent of earnings above that amount, resulting in a \$0 credit at \$9,770.

All income thresholds are indexed for inflation annually. In order to be a qualifying child, an individual must satisfy a relationship test, a residency test, and an age test. The relationship test requires that the individual be a child, stepchild, a descendant of a child, or a foster or adopted child of the taxpayer. The residency test requires that the individual have the same place of abode as the taxpayer for more than half the taxable year. The household must be located in the United States. The age test requires that the individual be under 19 (24 for a full-time student) or be permanently and totally disabled.

An individual is not eligible for the earned income credit if the aggregate amount of disqualified income of the taxpayer for the taxable year exceeds \$2,200. This threshold is indexed. Disqualified income is the sum of:

1. Interest (taxable and tax exempt),
2. Dividends,
3. Net rent and royalty income (if greater than zero),
4. Capital gains net income, and
5. Net passive income (if greater than zero) that is not self-employment income.

For taxpayers with earned income (or modified AGI, if greater) in excess of the beginning of the phaseout range, the maximum earned income credit amount is reduced by the phaseout rate multiplied by the amount of earned income (or modified AGI, if greater) in excess of the beginning of the phaseout range. For taxpayers with earned income (or modified AGI, if greater) in excess of the end of the phaseout range, no credit is allowed.

The definition of modified AGI used for phasing out the earned income credit disregards certain losses. The losses disregarded are:

1. Net capital losses (if greater than zero),
2. Net losses from trusts and estates,
3. Net losses from nonbusiness rents and royalties, and
4. Seventy-five percent of the net losses from businesses, computed separately with respect to sole proprietorships (other than in farming), sole proprietorships in farming, and other businesses.

The definition of modified AGI also includes tax-exempt interest and nontaxable distributions from pensions, annuities, and individual retirement accounts (but only if not called over into similar vehicles during the applicable rollover period).

Individuals are ineligible for the credit if they do not include their taxpayer identification number and their qualifying child's number (and, if married, their spouse's taxpayer identification number) on their tax return. Solely for these purposes and for purposes of the present-law identification test for a qualifying child, a taxpayer identification number is defined as a Social Security number issued to an individual by the Social Security Administration other than a number issued under section 205(c)(2)(B)(i)(II) (or that portion of sec. 205(c)(2)(B)(i)(III) relating to it) of the Social Security Act regarding the issuance of a number to an individual applying for or receiving federally funded benefits.

If an individual fails to provide a correct taxpayer identification number, such omission will be treated as a mathematical or clerical error by the Internal Revenue Service. Similarly, if an individual who claims the credit with respect to net earnings from self-employment fails to pay the proper amount of self-employment tax on such net earnings, the failure will be treated as a mathematical or clerical error for purposes of the amount of credit allowed.

The EIC is relatively unique because it is a refundable tax credit; i.e., if the amount of the credit exceeds the taxpayer's Federal income tax liability, the excess is payable to the taxpayer as a direct transfer payment. In this sense, the EIC is like other Federal programs that provide poor and low-income families with public benefits. However, the EIC differs from other Federal programs in that its benefits require earnings.

Under an advance payment system, available since 1979, eligible taxpayers may elect to receive the credit in their paychecks, rather than waiting to claim a refund on their tax return filed by April 15 of the following year. In 1993, Congress required that the IRS begin to notify eligible taxpayers of the advance payment option.

INTERACTION WITH MEANS-TESTED PROGRAMS

The treatment of the EIC for purposes of AFDC and food stamp benefit computations has varied since inception of the credit. When enacted in 1975, the credit was not considered income in determining AFDC and food stamp benefits, and the credit could not be received on an advance basis. From January 1979 through September 1981, the credit was treated as earned income when actually received.

From October 1981 to September 1984, the amount of the credit was treated as earned income and was imputed to the family even though it may not have been received as an advance payment. Pursuant to the Deficit Reduction Act of 1984, the credit was treated as earned income only when received, either as an advance payment or as a refund after the conclusion of the year.

Under the Family Support Act of 1988, States generally were required to disregard any advance payment or refund of the EIC when calculating AFDC eligibility or benefits. However, the credit was counted against the gross income eligibility standard (185 percent of the State need standard) for both applicants and recipients.

OBRA 1990 specified that, effective January 1, 1991, the EIC was not to be taken into account as income (for the month in which the payment is received or any following month) or as a resource (for the month in which the payment is received or the following

month) for determining the eligibility or amount of benefit for AFDC, Medicaid, SSI, food stamps, or low-income housing programs.

EFFECT OF PROVISION

More than 18.5 million taxpayers are expected to take advantage of the EIC in 1997 (see table 13–13). Their claims are expected to total \$26.8 billion, 81 percent of which will be refunded as direct payments to these families. As table 13–13 also shows, approximately 69 percent of the tax relief or direct spending from the EIC accrues to taxpayers who file as singles or heads of households.

Table 13–14 shows the total amount of earned income credit received for each of the calendar years since the inception of the program, the number of recipient families, the amount of the credit received as refunded payments, and the average amount of credit received per family.

EXCLUSION OF PUBLIC ASSISTANCE AND SSI BENEFITS

LEGISLATIVE HISTORY

While there is no specific statutory authorization, a number of revenue rulings under Code section 61 have held that specific types of public assistance payments are excludable from gross income. Revenue rulings generally exclude government transfer payments from income because they are considered to be general welfare payments. In addition, taxing benefits provided in kind, rather than in cash, would require valuation of these benefits, which could create administrative difficulties.

EXPLANATION OF PROVISION

The Federal Government provides tax-free public assistance benefits to individuals either by cash payments or by provision of certain goods and services at reduced cost or free of charge. Cash payments come mainly from the Aid to Families with Dependent Children (AFDC) and Supplemental Security Income (SSI) Programs. In-kind payments include food stamps, Medicaid, and housing assistance. None of these payments is subject to income tax.

DEPENDENT CARE TAX CREDIT

LEGISLATIVE HISTORY

Under section 21 of the Internal Revenue Code, taxpayers are allowed an income tax credit for certain employment-related expenses for dependent care. The Internal Revenue Code of 1954 provided a deduction to gainfully employed women, widowers, and legally separated or divorced men for certain employment-related dependent care expenses. The deduction was limited to \$600 per year and phased out for families with incomes between \$4,500 and \$5,100.

The Revenue Act of 1964 made husbands with incapacitated wives eligible for the dependent care deduction and raised the threshold for the income phaseout from \$4,500 to \$6,000.

TABLE 13-13.—DISTRIBUTION OF TAX PROVISIONS: EARNED INCOME CREDIT, 1997

Income class	Joint returns		Head of household and single returns		All returns	
	Number	Amount	Number	Amount	Number	Amount
\$0-\$10,000	681	\$924	4,495	\$4,816	5,175	\$5,740
\$10,000-\$20,000	1,615	3,592	4,824	9,270	6,439	12,862
\$20,000-\$30,000	2,038	2,873	3,067	3,900	5,106	6,773
\$30,000-\$40,000	920	711	730	602	1,650	1,313
\$40,000-\$50,000	112	93	18	18	130	111
\$50,000-\$75,000	29	35	5	12	33	47
\$75,000 and over	0	0	0	0	0	0
Total	5,394	8,229	13,139	18,618	18,534	26,847
Percent distribution by type of return	29.1	30.7	70.9	69.3	100.0	100.0

Note.—Number of returns in thousands; amount of credit in millions.

Source: Joint Committee on Taxation.

TABLE 13-14.—EARNED INCOME CREDIT: NUMBER OF RECIPIENTS AND AMOUNT OF CREDIT, 1975-2000

Year	Number of recipient families (thousands)	Total amount of credit (millions)	Refunded portions of credit (millions)	Average credit per family
1975	6,215	\$1,250	\$900	\$201
1976	6,473	1,295	890	200
1977	5,627	1,127	880	200
1978	5,192	1,048	801	202
1979	7,135	2,052	1,395	288
1980	6,954	1,986	1,370	286
1981	6,717	1,912	1,278	285
1982	6,395	1,775	1,222	278
1983	7,368	1,795	1,289	224
1984	6,376	1,638	1,162	257
1985	7,432	2,088	1,499	281
1986	7,156	2,009	1,479	281
1987	8,738	3,391	2,930	450
1988	11,148	5,896	4,257	529
1989	11,696	6,595	4,636	564
1990	12,542	7,542	5,266	601
1991	13,665	11,105	8,183	813
1992	14,097	13,028	9,959	924
1993	15,117	15,537	12,028	1,028
1994 ¹	19,017	21,105	16,598	1,110
1995 ²	19,335	25,956	20,829	1,342
1996 ²	18,525	25,935	20,826	1,400
1997 ²	18,652	26,919	21,684	1,443
1998 ²	18,788	27,677	22,452	1,473
1999 ²	18,954	28,728	23,416	1,516
2000 ²	19,212	29,921	24,380	1,557

¹ Preliminary.² Projected.

Source: For 1975-94, Internal Revenue Service; for 1995-2000, Joint Committee on Taxation.

The Revenue Act of 1971: (1) made any individual who maintained a household and was gainfully employed eligible for the deduction; (2) modified the definition of a dependent; (3) raised the deduction limit to \$4,800 per year; (4) increased from \$6,000 to \$18,000 the income level at which the deduction began to phase out; (5) allowed the deduction for household services in addition to direct dependent care; and (6) limited the deduction with respect to services outside the taxpayer's household.

The Tax Reduction Act of 1975 increased from \$18,000 to \$35,000 the income level at which the deduction began to be phased out.

The Tax Reform Act of 1976 replaced the deduction with a non-refundable credit. This change broadened eligibility to those who do not itemize deductions and provided relatively greater benefit to low-income taxpayers. In addition, the act eased the rules related to family status and simplified the computation.

In the Economic Recovery Tax Act of 1981, Congress provided a higher ceiling on creditable expenses, a larger credit for low-income individuals, and modified rules relating to care provided outside the home.

The Family Support Act of 1988 reduced to 13 the age of a child for whom the dependent care credit may be claimed, reduced the amount of eligible expenses by the amount of expenses excludable from that taxpayer's income under the dependent care exclusion, lowered from 5 to 2 the age at which a taxpayer identification number had to be submitted for children for whom the credit was claimed, and disallowed the credit unless the taxpayer reports on her tax return the correct name, address, and taxpayer identification number (generally, an employer identification number or a Social Security number) of the dependent care provider.

The Small Business Protection Act of 1996 required a TIN for all children for whom a dependent care credit may be claimed.

EXPLANATION OF PROVISION

A taxpayer may claim a nonrefundable credit against income tax liability for up to 30 percent of a limited amount of employment-related dependent care expenses. Eligible employment-related expenses are limited to \$2,400 if there is one qualifying dependent or \$4,800 if there are two or more qualifying dependents. Generally, a qualifying individual is a dependent under the age of 13 or a physically or mentally incapacitated dependent or spouse.

Employment-related dependent care expenses are expenses for the care of a qualifying individual incurred to enable the taxpayer to be gainfully employed, other than expenses incurred for an overnight camp. For example, amounts paid for the services of a housekeeper generally qualify if such services are performed at least partly for the benefit of a qualifying individual; amounts paid for a chauffeur or gardener do not qualify.

Expenses that may be taken into account in computing the credit generally may not exceed an individual's earned income or, in the case of married taxpayers, the earned income of the spouse with the lesser earnings. Thus, if one spouse is not working, no credit generally is allowed. Also, the amount of expenses eligible for the dependent care credit is reduced, dollar for dollar, by the amount of expenses excludable from that taxpayer's income under the dependent care exclusion (discussed below).

The 30-percent credit rate is reduced, but not below 20 percent, by 1 percentage point for each \$2,000 (or fraction thereof) of adjusted gross income (AGI) above \$10,000. Because married couples are required to file a joint return to claim the credit, a married couple's combined AGI is used for purposes of this computation.

EFFECT OF PROVISION

From 1976 to 1994, the number of families that claimed the dependent care credit increased from 2.7 to 6.0 million, the aggregate amount of credits claimed increased from \$0.5 to \$2.5 billion, and the average amount of credit claimed per family increased from \$206 to \$420 (see table 13-15). In 1997, 6.1 million families are expected to claim an average credit of \$448, for a total of \$2.7 billion.

TABLE 13-15.—DEPENDENT CARE TAX CREDIT: NUMBER OF FAMILIES AND AMOUNT OF CREDIT, 1976-98

Year	Number of re- turns claiming dependent credit (thou- sands)	Aggregate amount of credit claimed (millions)	Average credit claimed per return
1976	2,660	\$548	\$206
1977	2,910	521	179
1978	3,431	654	191
1979	3,833	793	207
1980	4,231	956	226
1981	4,578	1,148	251
1982	5,004	1,501	300
1983	6,367	2,051	322
1984	7,456	2,649	351
1985	8,417	3,127	372
1986	8,950	3,398	380
1987	8,520	3,438	404
1988	9,023	3,813	423
1989	6,028	2,440	405
1990	6,144	2,549	415
1991	5,896	2,521	427
1992	5,980	2,527	433
1993	6,090	2,559	419
1994	6,012	2,526	420
1995	5,964	2,518	445
1996	6,003	2,663	444
1997 ¹	6,063	2,714	448
1998 ²	6,124	2,770	452

¹ Preliminary.² Projected.

Source: Joint Committee on Taxation.

Changes made in the Family Support Act of 1988 reduced the use of the credit in 1989. The number of families who claimed the credit dropped by about one-third and the amount of credit claimed declined by \$1.373 billion.

Data for 1995 from the Internal Revenue Service show that about 13 percent of the benefit from the credit accrues to families with AGI of less than \$20,000; about 47 percent to families with AGI between \$20,000 and \$50,000; and about 40 percent to families with AGI above \$50,000.

HOPE CREDIT AND LIFETIME LEARNING CREDIT

The Taxpayer Relief Act of 1997 established the HOPE credit and the lifetime learning credit as nonrefundable credits against Federal income tax liability for qualified tuition and fees required for the attendance of an eligible student at an eligible educational institution.

The HOPE credit rate is 100 percent of the first \$1,000 of qualified tuition and fees per eligible student per year, and 50 percent of the next \$1,000 of qualified tuition and fees per eligible student

per year. The HOPE credit is available only for the first 2 years of postsecondary education. The qualified tuition and fees must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent. Charges and fees associated with meals, lodging, books, student activities, athletics, insurance, transportation, and similar personal, living, or family expenses are not eligible for the credit. An eligible student for purposes of the HOPE credit is a student enrolled in a degree, certificate, or other program on at least a half-time basis. Eligible educational institutions are defined by reference to section 481 of the Higher Education Act of 1965. Such institutions generally are accredited postsecondary educational institutions offering credit toward a bachelor's degree, an associate's degree, or another recognized postsecondary credential. Certain proprietary institutions and postsecondary vocational institutions are also eligible educational institutions. The HOPE credit is effective for expenses paid after December 31, 1997, for education furnished in academic periods beginning after such date. For taxable years beginning after 2001, the \$1,500 maximum HOPE credit amount will be indexed for inflation.

The lifetime learning credit rate is 20 percent of up to \$5,000 in qualified tuition and fees for a maximum credit of \$1,000. For expenses paid after December 31, 2002, up to \$10,000 in qualified tuition and fees will be eligible for the 20-percent credit, for a maximum credit of \$2,000. In contrast to the HOPE credit, the lifetime learning credit is available for an unlimited number of years of education. Also in contrast to the HOPE credit, which requires a half-time or greater enrollment status, the lifetime learning credit is available with respect to any course of instruction at an eligible educational institution to acquire or improve job skills, regardless of enrollment status. Qualified tuition and fees are defined in the same manner as under the HOPE credit provisions. As with the HOPE credit, eligible students are the taxpayer, the taxpayer's spouse, or a dependent. In contrast to the HOPE credit, the maximum amount of the lifetime learning credit that may be claimed on a taxpayer's return will not vary with the number of students in the taxpayer's family. The lifetime learning credit is effective for expenses paid after June 30, 1998, for education furnished in academic periods beginning after such date. The maximum lifetime learning credit amount is not indexed for inflation.

Eligibility for the HOPE credit and the lifetime learning credit is phased out ratably for taxpayers with modified AGI between \$40,000 and \$50,000 (\$80,000 and \$100,000 for joint returns). These phaseout ranges are indexed for inflation for taxable years beginning after 2001. For a taxable year, a taxpayer may elect with respect to an eligible student either the HOPE credit, the lifetime learning credit, or the exclusion from gross income for certain distributions from an education IRA. For purposes of both the HOPE credit and the lifetime learning credit, if a parent claims a child as a dependent, then only the parent may claim the credit.

QUALIFIED STATE TUITION PROGRAMS AND EDUCATION IRAs

The Taxpayer Relief Act of 1997 modified section 529 of the Tax Code, which governs the tax treatment of qualified State tuition programs. Section 529 was enacted as part of the Small Business Job Protection Act of 1996, and provides tax-exempt status and deferral of tax on earnings of qualified State tuition programs. The Taxpayer Relief Act of 1997 also provides that taxpayers may establish education IRAs.

Qualified State tuition programs are programs established and maintained by a State under which persons may: (1) purchase tuition credits on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary; or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expense of a designated beneficiary. Qualified higher education expenses are defined as tuition, fees, books, supplies, and equipment required for the enrollment of or attendance at a college or university (or certain vocational schools). The Taxpayer Relief Act of 1997 expanded the definition of qualified expenses to include room and board expenses. Contributions to State tuition programs are not deductible. Earnings on qualified State tuition programs are includable in income only when ultimately distributed. Distributions from a qualified State tuition program also entitle the distributee to claim either the HOPE or the lifetime learning credit with respect to education expenses paid with such distributions, assuming the other requirements for claiming the HOPE credit or the lifetime learning credit are satisfied. There are no income limits for participation in qualified State tuition programs, though contributions must be limited by the program to amounts no greater than an amount necessary to provide for the education of the beneficiary. The program must also impose a more than de minimis penalty on earnings not used for qualified expenses.

An education IRA is a trust or custodial account created exclusively for the purpose of paying qualified higher education expenses of a named beneficiary. Contributions to an education IRA are not deductible; earnings on contributions are not currently includable in income. Contributions to education IRAs are limited to \$500 per year per beneficiary. However, no contribution may be made by any person to an education IRA established on behalf of a beneficiary during any taxable year in which any contributions are made by anyone to a qualified State tuition program on behalf of the same beneficiary. The contribution limit is phased out ratably for contributors with modified AGI between \$95,000 and \$110,000 (\$150,000 and \$160,000 for joint returns). Qualified expenses are the same as those for the qualified State tuition programs, with the exception that room and board expenses are qualified expenses only if the student is enrolled on at least a half-time basis. Withdrawals of earnings from education IRAs are excludable from income provided that such withdrawals are used to pay for qualified higher education expenses. If the earnings are not used for qualified expenses, they are includable in income and are also subject to an additional 10-percent penalty tax. A taxpayer may not simul-

taneously claim an exclusion from income for distributions from an education IRA and claim either the HOPE credit or the lifetime learning credit.

STUDENT LOAN INTEREST DEDUCTION

The Taxpayer Relief Act of 1997 provided for the above-the-line deductibility of interest on qualified education loans. The deduction is allowed only with respect to interest paid during the first 60 months in which interest payments are required. A qualified education loan is generally defined as any indebtedness incurred to pay for the qualified higher education expenses of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending either postsecondary educational institutions and certain vocational schools defined by reference to section 481 of the Higher Education Act of 1965, or institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training. Qualified higher education expenses are defined as the student's cost of attendance as defined in section 472 of the Higher Education Act of 1965 (generally, tuition, fees, room and board, and related expenses), reduced by: (1) any amount excluded under section 135 (i.e., U.S. saving bonds used to pay higher education tuition and fees); (2) any amount distributed from an education IRA and excluded from gross income; and (3) the amount of any scholarship or fellowship grants excludable from gross income under section 117, as well as any other tax-free education benefits, such as employer-provided educational assistance that is excludable from the employee's gross income under section 127.

The maximum deduction is phased in gradually, with a \$1,000 maximum in 1998, \$1,500 in 1999, \$2,000 in 2000, and \$2,500 in 2001. The maximum deduction is not indexed for inflation, and the deduction is phased out ratably for individual taxpayers with modified AGI of \$40,000–\$55,000 (\$60,000–\$75,000 for joint returns). These income ranges will be indexed for inflation occurring after the year 2002, and rounded down to the closest multiple of \$5,000. This provision is effective for interest payments due and paid after December 31, 1997, on any qualified education loan.

EXCLUSION FOR EMPLOYER-PROVIDED DEPENDENT CARE

LEGISLATIVE HISTORY

The value of certain employer-provided dependent care is excluded from the employee's gross income. The Economic Recovery Tax Act of 1981 added this exclusion (sec. 129) and amended Code sections 3121(a)(18) and 3306(b)(13) to exclude such employer-provided dependent care from wages for purposes of the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA). The Tax Reform Act of 1986 modified the non-discrimination rules and limited the exclusion to \$5,000 a year (\$2,500 in the case of a separate return by a married individual). The Family Support Act of 1988 required the amount of employer-

provided dependent care excluded from the taxpayer's income to reduce, dollar for dollar, the amount of expenses eligible for the dependent care tax credit.

EXPLANATION OF PROVISION

Amounts paid or incurred by an employer for dependent care assistance provided to an employee generally are excluded from the employee's gross income if the assistance is furnished under a program meeting certain requirements. These requirements include that the program be described in writing, satisfy certain non-discrimination rules, and provide for notification to all eligible employees. The type of dependent care eligible for the exclusion is the same as the type eligible for the dependent care credit.

The dependent care exclusion is limited to \$5,000 per year except that a married taxpayer filing a separate return may exclude only \$2,500. Amounts excluded from gross income generally are excludable from wages for employment tax purposes. Dependent care expenses excluded from income are not eligible for the dependent care tax credit.

EFFECT OF PROVISION

The exclusion provides an incentive to taxpayers with expenses for dependent care to seek compensation in the form of dependent care assistance rather than in cash subject to taxation. This incentive is of greater value to employees in higher tax brackets.

Many employees covered by the exclusion for employer-provided dependent care also are eligible to use the dependent care tax credit. While the limitations on the exclusion and the credit differ, the credit generally is less valuable than the exclusion for taxpayers who are above the 15-percent tax bracket.

According to a survey of private firms with 100 or more workers conducted by the U.S. Bureau of Labor Statistics (1993), nearly one-tenth of full-time workers at these firms were eligible for child care benefits provided by the employer in the form of on-site or near-site child care facilities or through direct reimbursement of employee expenses. A more prevalent form of providing dependent care benefits is through reimbursement accounts, which may cover other nontaxable fringe benefits, such as out-of-pocket health care expenses, in addition to dependent care. Slightly over one-third of full-time employees at large- and medium-sized firms were eligible for such accounts in 1991.

WORK OPPORTUNITY TAX CREDIT

The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The targeted groups are: (1) families eligible to receive benefits under the Title IV-A Temporary Assistance for Needy Families Program (TANF; the successor to the Aid to Families with Dependent Children Program); (2) qualified ex-felons; (3) vocational rehabilitation referrals; (4) qualified summer youth employees; (5) qualified veterans; (6) youths who reside in an empowerment zone or enterprise community; (7) families receiving food stamps; and (8)

persons receiving certain Supplemental Security Income (SSI) benefits.

The credit generally is equal to 40 percent (25 percent for employment of 400 hours or less) of qualified wages. Qualified wages consist of wages attributable to service rendered by a member of a targeted group during the 1-year period beginning with the day the individual begins work for the employer. For a vocational rehabilitation referral, however, the period will begin on the day the individual begins work for the employer on or after the beginning of the individual's vocational rehabilitation plan as under prior law.

Generally, no more than \$6,000 of wages during the first year of employment is permitted to be taken into account with respect to any individual. Thus, the maximum credit per individual is \$2,400. With respect to qualified summer youth employees, the maximum credit is 40 percent of up to \$3,000 of qualified first-year wages, for a maximum credit of \$1,200.

In general, an individual is not to be treated as a member of a targeted group unless: (1) on or before the day the individual begins work for the employer, the employer received in writing a certification from the designated local agency that the individual is a member of a specific targeted group; or (2) on or before the day the individual is offered work with the employer, a prescreening notice is completed with respect to that individual by the employer and within 21 days after the individual begins work for the employer, the employer submits such notice, signed by the employer and the individual under penalties of perjury, to the designated local agency as part of a written request for certification. The prescreening notice will contain the information provided to the employer by the individual that forms the basis of the employer's belief that the individual is a member of a targeted group.

No credit is allowed for wages paid unless the eligible individual is employed by the employer for at least 120 hours. The credit percentage is 25 percent for employment of 400 hours or less, assuming that the minimum employment period is satisfied with respect to that employee. For employment of more than 400 hours, the credit percentage is 40 percent.

The credit is effective for wages paid or incurred to a qualified individual who begins work for an employer after September 30, 1996, and before July 1, 1998.

WELFARE-TO-WORK TAX CREDIT

The Code provides to employers a tax credit on the first \$20,000 of eligible wages paid to qualified long-term family assistance (TANF) recipients during the first 2 years of employment. The credit is 35 percent of the first \$10,000 of eligible wages in the first year of employment and 50 percent of the first \$10,000 of eligible wages in the second year of employment. The maximum credit is \$8,500 per qualified employee.

Qualified long-term family assistance recipients are: (1) members of a family that has received TANF benefits for at least 18 consecutive months ending on the hiring date; (2) members of a family that has received TANF benefits for a total of at least 18 months (whether or not consecutive) after the date of enactment of this credit if they are hired within 2 years after the date that the 18-

month total is reached; and (3) members of a family who are no longer eligible for TANF because of either Federal or State time limits, if they are hired within 2 years after the Federal or State time limits made the family ineligible for family assistance.

Eligible wages include cash wages paid to an employee plus amounts paid by the employer for the following: (1) educational assistance excludable under a section 127 program (or that would be excludable but for the expiration of sec. 127); (2) health plan coverage for the employee, but not more than the applicable premium defined under section 4980B(f)(4); and (3) dependent care assistance excludable under section 129.

The welfare to work credit is effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 1998 and before May 1, 1999.

EXCLUSION OF WORKERS' COMPENSATION AND SPECIAL BENEFITS FOR DISABLED COAL MINERS

LEGISLATIVE HISTORY

Workers' compensation benefits generally are not taxable under section 104(a)(1) of the Internal Revenue Code of 1986. Workers' compensation benefits are treated as Social Security benefits to the extent that they reduce Social Security benefits received (see above). This exclusion from gross income was first codified in the Revenue Act of 1918. The Ways and Means Committee report for that act suggests that such payments were not subject to tax even prior to the 1918 act.

Payments made to coal miners or their survivors for death or disability resulting from pneumoconiosis (black lung disease) under the Federal Coal Mine Health and Safety Act of 1969 (as amended) are excluded from gross income. Payments made as a result of claims filed before December 31, 1972 originally were excluded from Federal income tax by the Federal Coal Mine Health and Safety Act of 1969. Later payments are excluded from gross income because they are considered to be in the nature of workers' compensation (Rev. Rul. 72-400, 1972-2 C.B. 75).

EXPLANATION OF PROVISION

Gross income does not include amounts received as workers' compensation for personal injuries or sickness. This exclusion also applies to benefits paid under a workers' compensation act to a survivor of a deceased employee.

Benefits for disabled coal miners (black lung benefits) are not includable in gross income.

There are two types of black lung programs. The first involves Federal payments to coal miners and their survivors due to death or disability, payable for claims filed before July 1, 1973 (December 31, 1973, in the case of survivors). This program provided total annual payments of around \$672 million to approximately 143,000 beneficiaries in December 1995 (Social Security Administration, 1996).

The second program requires coal mine operators to ensure payment of black lung benefits for claims filed on or after July 1, 1973

(December 31, 1973, in the case of survivors) in a federally mandated workers' compensation program. Benefits include medical treatment as well as cash payments. These benefits are paid from a trust fund financed by an excise tax on coal production if there is no responsible operator (an operator for whom the miner worked for at least 1 year) or if the responsible operator is in default. This program provided total annual payments of around \$610 million to approximately 156,550 claimants in 1986 (U.S. Department of Labor, 1989, tables 3 & 6).

ADDITIONAL STANDARD DEDUCTION FOR THE ELDERLY AND BLIND

LEGISLATIVE HISTORY

From 1954 through 1986, an additional personal exemption was allowed for a taxpayer or a spouse who was 65 years or older at the close of the year. An additional personal exemption also was allowed for a taxpayer or a spouse who was blind.

The Tax Reform Act of 1986 repealed the additional personal exemption for the elderly and blind and replaced it with an additional standard deduction amount. These additional standard deduction amounts are adjusted for inflation.

EXPLANATION OF PROVISION

The additional standard deduction amount for the elderly or the blind is \$800 in 1997 for an elderly or a blind individual who is married (whether filing jointly or separately) or is a surviving spouse, and \$1,600 for such an individual who is both elderly and blind. The additional amount is \$1,000 for a head of household who is elderly or blind (\$2,000, if both), and for a single individual (i.e., an unmarried individual other than a surviving spouse or head of household) who is elderly or blind.

The definitions of elderly and blind status have not been changed since 1954. An elderly person is an individual who is at least 65 years of age. Blindness is defined in terms of the ability to correct a deficiency in distance vision or the breadth of the area of vision. An individual is blind only if central vision acuity is not better than 20/200 in the better eye with correcting lenses, or if visual acuity is better than 20/200 but is accompanied by a limitation in the fields of vision such that the widest diameter of the visual field subtends an angle no greater than 20 degrees.

EFFECT OF PROVISION

The additional standard deduction increases the tax threshold for elderly and blind taxpayers. For example, the additional amount is \$1,600 for two elderly individuals filing a joint return, raising the tax threshold in 1997 from \$12,200 to \$13,800.

In 1995, about 10.8 million taxpayers claimed the extra standard deduction. About 85 percent of the 10.8 million beneficiaries had incomes of less than \$40,000.

TAX CREDIT FOR THE ELDERLY AND CERTAIN DISABLED INDIVIDUALS

LEGISLATIVE HISTORY

The present tax credit for individuals who are age 65 or over, or who have retired on permanent and total disability, was enacted in the Social Security Amendments of 1983 (Code sec. 22). This credit replaced the previous credit for the elderly, which had been enacted in the Tax Reform Act of 1976. Prior to that provision, the tax law provided a retirement income credit, which initially was enacted in the Internal Revenue Code of 1954.

EXPLANATION OF PROVISION

Individuals who are age 65 or older may claim a nonrefundable income tax credit equal to 15 percent of a base amount. The credit also is available to an individual, regardless of age, who is retired on disability and who was permanently and totally disabled at retirement. For this purpose, an individual is considered permanently and totally disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death, or that has lasted or can be expected to last for a continuous period of not less than 12 months. The individual must furnish proof of disability to the IRS.

The maximum base amount for the credit is \$5,000 for unmarried elderly or disabled individuals and for married couples filing a joint return if only one spouse is eligible; \$7,500 for married couples filing a joint return with both spouses eligible; or \$3,750 for married couples filing separate returns. For a nonelderly, disabled individual the initial base amount is the lesser of the applicable specified amount or the individual's disability income for the year. Consequently, the maximum credit available is \$750 (15 percent of \$5,000), \$1,125 (15 percent of \$7,500), or \$562.50 (15 percent of \$3,750).

The maximum base amount is reduced by the amount of certain nontaxable income of the taxpayer, such as nontaxable pension and annuity income or nontaxable Social Security, railroad retirement, or veterans' nonservice-related disability benefits. In addition, the base amount is reduced by one-half of the taxpayer's AGI in excess of certain limits: \$7,500 for a single individual, \$10,000 for married taxpayers filing a joint return, or \$5,000 for married taxpayers filing separate returns. These computational rules reflect that the credit is designed to provide tax benefits to individuals who receive only taxable retirement or disability income, or who receive a combination of taxable retirement or disability income plus Social Security benefits that generally are comparable to the tax benefits provided to individuals who receive only Social Security benefits (including Social Security disability benefits).

EFFECT OF PROVISION

In 1995, \$48 million in elderly and disabled credit was claimed. Though the number of families claiming the credit has fallen significantly, the average credit granted has been relatively stable

since the credit was modified by the Social Security Amendments of 1983, as shown in table 13–16.

TABLE 13–16.—CREDIT FOR THE ELDERLY AND DISABLED, 1976–96

Year	Number of families that received credit (thousands)	Total amount of credit (millions)	Average credit per return
1976	1,011	\$206	\$204
1977	569	93	163
1978	689	145	210
1979	607	132	217
1980	562	135	240
1981	474	124	262
1982	483	131	271
1983	423	116	275
1984	475	107	225
1985	460	106	230
1986	430	86	200
1987	354	67	189
1988	357	69	193
1989	320	65	202
1990	342	63	183
1991	285	57	200
1992	240	51	213
1993	223	49	220
1994	222	47	210
1995 ¹	252	48	191
1996 ²	193	40	206

¹ Preliminary.

² Projected.

Source: Joint Committee on Taxation.

TAX PROVISIONS RELATED TO HOUSING

OWNER-OCCUPIED HOUSING

Legislative history

Deductibility of mortgage interest.—Prior to the Tax Reform Act of 1986, all interest payments on indebtedness incurred for personal use (e.g., to purchase consumption goods) were deductible in computing taxable income. The 1986 act amended section 163(h) of the Internal Revenue Code to disallow deductions for all personal interest except for interest on indebtedness secured by a first or second home.

In the Omnibus Budget Reconciliation Act of 1987, Congress further restricted the deductibility of mortgage interest. Only two classes of interest were distinguished as deductible: interest on acquisition indebtedness and interest on home equity indebtedness. Acquisition indebtedness, defined as indebtedness secured by a residence and used to acquire or improve the residence by which it is secured, was limited to \$1,000,000 (\$500,000 in the case of a married individual filing a separate return). Home equity indebtedness,

defined as any nonacquisition indebtedness secured by a residence (for example, a home equity loan), was limited to the lesser of \$100,000 (\$50,000 for married taxpayers filing separately) or the excess of the fair market value of the residence over the acquisition indebtedness.

Exclusion of capital gains for certain taxpayers.—In the Revenue Act of 1964, Congress introduced section 121 of the Internal Revenue Code of 1954, which permitted a one-time exclusion of all or part of the gain on the sale of a principal residence by older individuals. This exclusion was limited to homeowners who had lived in the property as a principal residence for 5 out of the last 8 years before the property's sale or exchange. Furthermore, full exclusion was permitted only for houses that sold for \$20,000 or less.

The parameters of this exclusion have been modified and expanded a number of times. Most recently, the Taxpayer Relief Act of 1997 significantly expanded the exclusion (e.g., the age 55 requirement was repealed).

Explanation of provisions

Homeowners may deduct a number of expenses related to housing as itemized deductions in computing taxable income. These include payments of interest on qualified residence debt, certain interest on home equity loans, certain payments of points (i.e., up front interest payments) on the purchase of a house, and payments of real property taxes. Interest on acquisition debt of \$1,000,000 or less is fully deductible, as is any interest on debt secured by a residence that was incurred on or before October 13, 1987. Interest on home equity indebtedness of \$100,000 is fully deductible for regular tax purposes, as long as the total amount of debt (acquisition plus home equity indebtedness) does not exceed the fair market value of the house. Interest on home equity indebtedness exceeding \$100,000 (and incurred after October 13, 1987) or exceeding the difference between the fair market value of the home and the acquisition indebtedness is not deductible. Interest paid on home equity loans is generally not deductible in computing the alternative minimum tax.

Under present law, a taxpayer generally is able to exclude up to \$250,000 (\$500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. The exclusion is allowed each time a taxpayer selling or exchanging a principal residence meets the eligibility requirements, but generally no more frequently than once every 2 years.

To be eligible for the exclusion, a taxpayer must have owned the residence and occupied it as a principal residence for at least 2 of the 5 years prior to the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or other unforeseen circumstances is able to exclude the fraction of the \$250,000 (\$500,000 if married filing a joint return) equal to the fraction of 2 years that these requirements are met.

Effects of provisions

Preliminary tax return information for 1995 indicates that 28 million taxpayers claimed the deduction for mortgage interest. Reli-

able data are not yet available on how many claimed the one-time exclusion.

The favorable treatment of owner-occupied housing may affect both the home ownership rate and the share of total investment in housing in the United States.

The home ownership tax provisions may benefit neighborhoods because they encourage home ownership and home improvement. The United States has maintained a high rate of home ownership—65 percent of all American households own the homes they live in (U.S. Bureau of the Census, 1995, p. 733, table 1225).

The tax advantages for owner-occupied housing encourage people to invest in homes instead of taxable business investments. This shift may reduce investment in business assets in the United States. One study suggested that housing capital is 25 percent higher and other capital is 12 percent lower than it would be if tax policy provided equal treatment for all forms of capital (Mills, 1987). Currently, about one-third of net private investment goes into owner-occupied housing, so even a modest shift of investment to other assets could have sizable effects.

LOW-INCOME HOUSING CREDIT

Legislative history

The low-income rental housing tax credit was first enacted in the Tax Reform Act of 1986. The Omnibus Budget Reconciliation Act of 1989 substantially modified the credit. The Omnibus Budget Reconciliation Act of 1993 modified the credit again and made it permanent.

Explanation of provision

A tax credit may be claimed by owners of residential rental property used for low-income rental housing. The credit is claimed annually, generally for a period of 10 years. New construction and rehabilitation expenditures for low-income housing projects are eligible for a maximum 70-percent present value credit, claimed annually for 10 years. The acquisition cost of existing projects that meet the substantial rehabilitation requirements and the cost of newly constructed projects receiving other Federal subsidies are eligible for a maximum 30-percent present value credit, also claimed annually for 10 years. These credit percentages are adjusted monthly based on an Applicable Federal Rate.

The credit amount is based on the qualified basis of the housing units serving the low-income tenants. A residential rental project will qualify for the credit only if: (1) 20 percent or more of the aggregate residential rental units in the project are occupied by individuals with 50 percent or less of area median income; or (2) 40 percent or more of the aggregate residential rental units in the project are occupied by individuals with 60 percent or less of area median income. These income figures are adjusted for family size. Maximum rents that may be charged families in units on which a credit is claimed depend on the number of bedrooms in the unit. The rent limitation is 30 percent of the qualifying income of a family deemed to have a size of 1.5 persons per bedroom (e.g., a two-

bedroom unit has a rent limitation based on the qualifying income for a family of three).

Credit eligibility also depends on the existence of a 30-year extended low-income use agreement for the property. If property on which a low-income housing credit is claimed ceases to qualify as low-income rental housing or is disposed of before the end of a 15-year credit compliance period, a portion of the credit may be recaptured. The 30-year extended use agreement creates a State law right to enforce low-income use for an additional 15 years after the initial 15-year recapture period.

In order for a building to be a qualified low-income building, the building owner generally must receive a credit allocation from the appropriate credit authority. An exception is provided for property that is substantially financed with the proceeds of tax-exempt bonds subject to the State's private-activity bond volume limitation. The low-income housing credit is allocated by State or local government authorities subject to an annual limitation for each State based on State population. The annual credit allocation per State is \$1.25 per resident.

Effect of provision

Comprehensive data from tax returns concerning the low-income housing tax credit are unavailable. Table 13-17 presents data from a survey of State credit allocating agencies. These data indicate that annual allocation of available credit authority generally has been 67 percent or greater. Year-to-year variations in credit allocation probably reflect changes in Federal law affecting the credit and changing economic conditions affecting the construction and housing markets. For example, 1990 was the first year following substantial modification to the credit and included a temporary period during which State credit allocating agencies were limited to allocating authority of \$0.9375 per capita rather than the \$1.25 per capita of present and prior law.

TABLE 13-17.—ALLOCATION OF THE LOW-INCOME HOUSING CREDIT, 1987-96

Years	Authority (millions)	Allocated (millions)	Allocated (percent)
1987	\$313.1	\$62.9	20.1
1988	311.5	209.8	67.4
1989	314.2	307.2	97.8
1990	317.7	213.1	67.0
1991 ¹	497.3	400.6	80.6
1992 ¹	476.8	332.7	70.0
1993 ¹	546.4	424.7	77.7
1994 ¹	523.7	495.5	94.7
1995 ¹	432.6	410.9	95.0
1996 ¹	391.6	379.9	97.0

¹ Increased authority includes credits unallocated from prior years carried over to the current year.

Source: Survey of State allocating agencies conducted by the National Council of State Housing Agencies (1996).

An allocation percentage of less than 100 percent does not imply that some credits available for allocation to low-income housing projects go unused. Since 1990, States are permitted to carry forward unused credit subsequently made available for allocation by other States. Thus, the amount allocated in any 1 year could be less than the States' authority, but such authority may ultimately be allocated.

TAX CREDIT AND EXCLUSION FOR ADOPTION EXPENSES

The Small Business Job Protection Act of 1996 (Public Law 104-188), signed into law on August 20, 1996, includes two tax provisions designed to reduce economic barriers to adoption. First, a tax credit of up to \$5,000 (or \$6,000 in the case of families adopting special-needs children from the United States) is created to help defray one-time adoption expenses. The credit is phased out for families with incomes above \$75,000, and is unavailable to families with incomes above \$115,000. Second, employees may receive an income tax exclusion of up to \$5,000 per child (or \$6,000 in the case of special-needs children) for employer-provided adoption assistance. The effective date for both provisions is January 1, 1997. The credit for foreign special-needs adoptions and the exclusion are not available after December 31, 2001.

CHILD TAX CREDIT

The Taxpayer Relief Act of 1997 provided for a \$500 (\$400 for taxable year 1998) tax credit for each qualifying child under the age of 17. A qualifying child is defined as an individual for whom the taxpayer can claim a dependency exemption and who is a son or daughter of the taxpayer (or a descendant of either), a stepson or stepdaughter of the taxpayer, or an eligible foster child of the taxpayer. For taxpayers with modified adjusted gross income in excess of certain thresholds, the allowable child credit is phased out.

Generally, the maximum amount of the child credit for each taxable year cannot exceed the excess of the taxpayer's regular tax liability over the taxpayer's tentative minimum tax liability (determined without regard to the alternative minimum foreign tax credit). In the case of a taxpayer with three or more qualifying children, the maximum amount of the child credit for each taxable year cannot exceed the greater of: (1) the general rule (described above), or (2) an amount equal to the excess of the sum of the taxpayer's regular income tax liability (net of applicable credits other than the earned income credit) and the employee share of FICA (and one-half of the taxpayer's SECA tax liability, if applicable) reduced by the earned income credit. In the case of a taxpayer with three or more qualifying children, the excess of the amount allowed in (2) over the amount computed in (1) is a refundable credit.

For taxpayers with modified AGI in excess of certain thresholds, the child credit is phased out. The phaseout rate is \$50 for each \$1,000 of modified AGI (or fraction thereof) in excess of the threshold. For these purposes modified AGI is computed by increasing the taxpayer's AGI by the amount otherwise excluded under Code sections 911, 931, and 933 (relating to the exclusion of income of U.S.

citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands; and residents of Puerto Rico, respectively). For married taxpayers filing joint returns, the threshold is \$110,000. For taxpayers filing single or head of household returns, the threshold is \$75,000. For married taxpayers filing separate returns, the threshold is \$55,000. These thresholds are not indexed for inflation.

THE EFFECT OF TAX PROVISIONS ON THE INCOME AND TAXES OF THE ELDERLY AND THE POOR

Tables 13–18 and 13–19 present values of the personal exemptions, standard deductions, additional standard deductions for the elderly and the blind, and taxable income brackets for 1990–2002. The figures for 1998–2002 are based on Congressional Budget Office projections. As might be expected, the value to taxpayers of personal exemptions, standard deductions, and additional standard deductions for the elderly and the blind grows steadily over the 10-year period.

HYPOTHETICAL TAX CALCULATIONS FOR SELECTED FAMILIES

Table 13–20 presents examples of tax liabilities for hypothetical taxpayers. The table presents 1997 Federal income and payroll tax burdens. The worker is assumed to bear both the employer and employee shares of FICA tax (7.65 percent for each). Taxpayers claim the earned income credit, if eligible, and they claim the standard deduction, except where noted in the footnotes. Income sources are listed in the table's footnotes for each example.

TAX TREATMENT OF THE ELDERLY

Present law contains several provisions that reduce, or in some cases eliminate, the burden of Federal income tax on senior citizens. These provisions are: the exemption from income taxation of some or all of an individual's Social Security benefits; a tax credit for certain taxpayers who do not receive substantial Social Security income; and an additional standard deduction for taxpayers age 65 and older. These are described in detail in preceding portions of this section.

As a result of these favorable tax provisions, the tax threshold (the level of income, excluding Social Security, at which tax liability is incurred) for elderly taxpayers is very close to or above the poverty level. For example, in 1996, a single elderly individual with \$5,000 in Social Security benefits can have up to \$7,200 in other income without incurring tax liability (or total income of \$12,200). An elderly married couple filing jointly with \$5,000 in excluded Social Security benefits has a tax threshold of \$13,500 (or total income of \$18,500). By comparison, the poverty levels in 1995 for a single elderly person and an elderly couple were \$7,309 and \$9,221, respectively (U.S. Bureau of the Census, 1995). Table 13–21 displays similar information for other years and for varying amounts of Social Security benefits.

TABLE 13-18.—ACTUAL PERSONAL EXEMPTIONS, STANDARD DEDUCTIONS, AND TAXABLE INCOME LEVELS, 1990-97

Exemption, deduction, or income level	1990	1991	1992	1993	1994	1995	1996	1997
Personal exemptions	\$2,050	\$2,150	\$2,300	\$2,350	\$2,450	\$2,500	\$2,550	\$2,650
Standard deductions:								
Joint	5,450	5,700	6,000	6,200	6,350	6,550	6,700	6,900
Single	3,250	3,400	3,600	3,700	3,800	3,900	4,000	4,150
Head of household	4,750	5,000	5,250	5,450	5,600	5,750	5,900	6,050
Additional standard deductions for elderly/blind:								
Joint (each individual)	650	650	700	700	750	750	800	800
Single/head of household	800	850	900	900	950	950	1,000	1,000
Taxable income levels:								
Joint returns:								
15-percent rate ends at	32,450	34,000	35,800	36,900	38,000	39,000	40,100	41,200
28-percent rate ends at	78,400	82,150	86,500	89,150	91,850	94,250	96,900	99,600
31-percent rate ends at .....	.....	.....	.....	140,000	140,000	143,600	147,700	151,750
Single returns:								
15-percent rate ends at	19,450	20,350	21,450	22,100	22,750	23,350	24,000	24,650
28-percent rate ends at	47,050	49,300	51,900	53,500	55,100	56,550	58,150	59,750
31-percent rate ends at .....	.....	.....	.....	115,000	115,000	117,950	121,300	124,650
Heads of household:								
15-percent rate ends at	26,050	27,300	28,750	29,600	30,500	31,250	32,150	33,050
28-percent rate ends at	67,200	70,450	74,150	76,400	78,700	80,750	83,050	85,350
31-percent rate ends at .....	.....	.....	.....	127,500	127,500	130,800	134,500	138,200
39.6-percent rate ends at .....	.....	.....	.....	250,000	250,000	256,500	263,750	271,050

Source: Congressional Budget Office.

TABLE 13-19.—PROJECTED PERSONAL EXEMPTIONS, STANDARD DEDUCTIONS, AND TAXABLE INCOME LEVELS, 1998-2007

Exemption, deduction, or income level	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Personal exemptions	\$2,700	\$2,800	\$2,900	\$2,950	\$3,050	\$3,150	\$3,250	\$3,350	\$3,450	\$3,550
Standard deductions:										
Joint	7,100	7,300	7,550	7,750	8,000	8,250	8,500	8,750	9,000	9,300
Single	4,250	4,400	4,500	4,650	4,800	4,950	5,100	5,250	5,400	5,550
Head of household	6,250	6,450	6,650	6,800	7,050	7,250	7,450	7,700	7,900	8,150
Additional standard deductions for elderly/blind:										
Joint (each individual)	850	850	900	900	950	950	1,000	1,050	1,050	1,100
Single/head of household	1,050	1,100	1,100	1,150	1,200	1,200	1,250	1,300	1,350	1,350
Taxable income levels:										
Joint returns:										
15-percent rate ends at	42,400	43,650	44,950	46,250	47,650	49,100	50,550	52,100	53,700	55,350
28-percent rate ends at	102,500	105,500	108,600	111,800	115,150	118,600	122,200	125,900	129,750	133,750
31-percent rate ends at	156,200	160,750	165,500	170,400	175,450	180,750	186,200	191,850	197,750	203,850
Single returns:										
15-percent rate ends at	25,400	26,150	26,900	27,700	28,550	29,400	30,250	31,200	32,150	33,150
28-percent rate ends at	61,500	63,300	65,150	67,100	69,100	71,150	73,300	75,550	77,850	80,250
31-percent rate ends at	128,300	132,050	135,950	139,950	144,150	148,450	152,950	157,600	162,450	167,450
Heads of household:										
15-percent rate ends at	34,000	35,000	36,050	37,100	38,200	39,350	40,550	41,800	43,050	44,400
28-percent rate ends at	87,850	90,400	93,050	95,800	98,650	101,650	104,700	107,900	111,200	114,650
31-percent rate ends at	142,250	146,400	150,700	155,150	159,800	164,000	169,550	174,750	180,100	185,650
39.6-percent rate ends at	278,900	287,050	295,550	304,300	313,350	322,750	332,500	342,650	353,150	364,050

Source: Congressional Budget Office.

TABLE 13-20.—EXAMPLES OF FEDERAL INCOME AND PAYROLL TAX LIABILITIES OF
HYPOTHETICAL TAXPAYERS, 1997

Type of filing unit and income	Income tax liability	FICA tax liability	Total tax liability	Overall effective tax rate (percent) ¹	Overall marginal tax rate (percent) ¹
Joint filer—3 exemptions: ²					
\$10,000	—\$2,210	\$1,530	—\$680	— 6.3	14.2
\$30,000	2,273	4,590	6,863	21.3	28.1
\$50,000 ³	4,808	7,650	12,458	23.1	28.1
\$100,000 ⁴	14,818	11,010	25,828	24.5	30.5
Head of household—2 exemptions: ²					
\$10,000	— 2,210	1,530	— 680	— 6.3	14.2
\$30,000	2,798	4,590	7,388	22.9	28.1
\$50,000 ³	5,420	7,650	13,070	24.3	40.2
\$100,000 ⁴	16,620	11,010	27,630	26.2	30.5
Elderly couple filing joint return:					
\$10,000 ⁵	0	0	0	0.0	⁶ 0.0
\$30,000 ⁷	630	0	630	2.1	⁸ 15.0
\$50,000 ⁹	4,530	1,530	6,060	11.9	40.0
Elderly single filer:					
\$10,000 ¹⁰	0	0	0	0.0	⁶ 0.0
\$30,000 ¹¹	2,205	0	2,205	7.4	¹² 22.5
\$50,000 ¹³	8,297	3,060	11,357	22.0	40.2

¹ The average tax rate is total tax liability divided by income plus the employer share of FICA. The marginal rate computations also count the employer share of FICA tax as income to the employee (for both payroll and income tax purposes). Unless otherwise noted, all calculations assume the taxpayer takes the standard deduction rather than itemized deductions.

² Assumes one child, one earner, and all income is wage income.

³ Assumes taxpayer claims itemized deductions of \$10,000.

⁴ Assumes taxpayer claims itemized deductions of \$20,000.

⁵ All income is Social Security.

⁶ If the marginal dollar of income is assumed to consist of wage income, the marginal tax rate would be 14.2 percent. This represents the FICA tax liability on this income.

⁷ Of the total, \$12,000 is Social Security, \$12,000 is a taxable pension, and \$6,000 is taxable interest.

⁸ If the marginal dollar of income is assumed to consist of wage income, the marginal tax rate would be 28.1 percent, representing both the income tax liability and the FICA tax liability on this income.

⁹ Same as above plus additional \$10,000 of taxable interest and \$10,000 of wages.

¹⁰ Of the total, \$7,500 is Social Security and \$2,500 is taxable pension.

¹¹ Of the total, \$7,500 is Social Security, \$7,500 is taxable pension, and \$15,000 is taxable interest.

¹² If the marginal dollar of income is assumed to consist of wage income, the marginal tax rate would be 35.1 percent, representing both the income tax liability (22.5-percent marginal rate reflects the inclusion of 50 cents of Social Security benefits as taxable for each additional dollar of AGI) and the FICA tax liability on this income.

¹³ Same as above plus \$20,000 of wages.

Source: Joint Committee on Taxation.

TABLE 13–21.—INCOME TAX THRESHOLDS FOR ELDERLY INDIVIDUALS WITH VARIOUS AMOUNTS OF SOCIAL SECURITY INCOME, 1990–2007

Year and filing status	Amount of Social Security income			
	None	\$2,500	\$5,000	\$7,500
1990:				
Single	\$9,900	\$8,233	\$6,100	\$6,100
Joint	15,567	13,900	12,233	10,850
1991:				
Single	10,100	8,433	6,400	6,400
Joint	15,867	14,200	12,533	11,300
1992:				
Single	10,367	8,700	6,800	6,800
Joint	16,333	14,667	13,000	12,000
1993:				
Single	10,467	8,800	6,950	6,950
Joint	16,533	14,867	13,200	12,300
1994:				
Single	10,633	8,967	7,200	7,200
Joint	16,833	15,167	13,500	12,750
1995:				
Single	10,733	9,067	7,350	7,350
Joint	17,033	15,367	13,700	13,050
1996:				
Single	10,867	9,200	7,550	7,550
Joint	17,267	15,600	13,933	13,400
1997:				
Single	11,033	9,367	7,800	7,800
Joint	17,533	15,867	14,200	13,800
1998 ¹ :				
Single	11,167	9,500	8,000	8,000
Joint	17,800	16,133	14,467	14,200
1999 ¹ :				
Single	11,367	9,700	8,300	8,300
Joint	18,067	16,400	14,733	14,600
2000 ¹ :				
Single	11,500	9,833	8,500	8,500
Joint	18,433	16,767	15,100	15,150
2001 ¹ :				
Single	11,667	10,000	8,750	8,750
Joint	18,633	16,967	15,300	15,450
2002 ¹ :				
Single	11,867	10,200	9,050	9,050
Joint	19,000	17,333	15,667	16,000
2003 ¹ :				
Single	12,033	10,367	9,300	9,300
Joint	19,300	17,633	15,967	16,450

TABLE 13–21.—INCOME TAX THRESHOLDS FOR ELDERLY INDIVIDUALS WITH VARIOUS AMOUNTS OF SOCIAL SECURITY INCOME, 1990–2007—Continued

Year and filing status	Amount of Social Security income			
	None	\$2,500	\$5,000	\$7,500
2004 ¹ :				
Single	12,233	10,567	9,600	9,600
Joint	19,667	18,000	16,333	17,000
2005 ¹ :				
Single	12,433	10,767	9,900	9,900
Joint	20,033	18,367	16,700	17,550
2006 ¹ :				
Single	12,633	10,967	10,200	10,200
Joint	20,333	18,667	17,000	18,000
2007 ¹ :				
Single	12,800	11,133	10,450	10,450
Joint	20,733	19,067	17,400	18,600

¹ Projections.

Source: Congressional Budget Office.

The combination of these tax provisions means that an estimated 51 percent of elderly individuals will have no tax liability for 1998 (see table 13–22).

DISTRIBUTION OF FAMILY INCOME AND TAXES

Table 13–22 presents estimates of the distribution of families and individuals by the Federal individual income tax rate brackets for calendar year 1998. As shown in the bottom panel, almost 33 million families pay no Federal income taxes. There are 55 million families with 134 million individuals who are in the 15-percent bracket. These families on average had income of \$37,645 and paid Federal taxes of \$2,474 per family. There are approximately 4 million families that face marginal income tax rates of 31 percent or above.

Table 13–23 is a more complicated version of table 13–22. It illustrates for various types of wage earners the additional (marginal) Federal tax these wage earners will pay if they earn one more dollar of wages. For purposes of this table, marginal tax rates include both Federal income and payroll taxes. The majority of single wage earners have income below \$30,000 per year and face marginal tax rates of 20.0–24.9 percent. In addition, the phaseout of certain deductions or exclusions under the Code (e.g., the personal exemption phaseout) and the overall limitation on itemized deductions also have the effect of imposing additional dollars of tax liability on a taxpayer as the taxpayer's income increases. Hence, effective marginal tax rates can exceed the sum of the statutory individual income tax rate and payroll tax rate.

TABLE 13-22.—DISTRIBUTION OF FAMILIES AND PERSONS BY MARGINAL FEDERAL INCOME TAX RATE, PROJECTED 1998

Family type and marginal tax rate (percent)	Families (in thousands)		Persons (in thousands)		Families	
	Number	Percent	Number	Percent	Average pretax income	Average Federal income tax
With children:						
0	9,916	25.4	37,446	24.8	\$11,804	—\$1,407
15	20,041	51.3	77,591	51.4	45,735	2,623
28	7,674	19.6	30,211	20.0	98,722	11,377
31	783	2.0	3,085	2.0	179,456	29,126
36	361	0.9	1,510	1.0	265,265	50,216
39.6	304	0.8	1,274	0.8	749,899	201,894
Total	39,078	100.0	151,116	100.0	57,707	5,838
With aged head:						
0	11,273	50.5	16,269	45.5	15,292	—7
15	8,038	36.0	13,937	39.0	38,222	2,054
28	2,325	10.4	4,303	12.0	86,015	10,327
31	436	2.0	716	2.0	150,662	24,454
36	175	0.8	331	0.9	293,016	57,054
39.6	93	0.4	174	0.5	997,948	202,334
Total	22,339	100.0	35,729	100.0	39,799	3,575
Other families:						
0	9,592	18.4	12,231	14.9	6,978	—110
15	26,942	51.5	42,531	51.8	32,422	2,567
28	13,291	25.4	22,976	28.0	75,353	9,749
31	1,544	3.0	2,528	3.1	141,044	23,018
36	551	1.1	1,058	1.3	254,622	50,215
39.6	355	0.7	748	0.9	905,846	223,378
Total	52,275	100.0	82,073	100.0	50,145	6,506
All families:						
0	30,780	27.1	65,946	24.5	11,578	—490
15	55,021	48.4	134,059	49.9	38,118	2,512
28	23,290	20.5	57,490	21.4	84,117	10,343
31	2,763	2.4	6,330	2.4	153,445	24,975
36	1,087	1.0	2,899	1.1	264,333	51,316
39.6	751	0.7	2,195	0.8	854,156	212,091
Total	113,692	100.0	268,918	100.0	50,711	5,700

Source: Congressional Budget Office tax simulation model.

TABLE 13-23.—DISTRIBUTION OF EARNERS¹ BY INCOME AND MARGINAL TAX RATES ON WAGES, PROJECTED 1998

Family type and marginal tax rate (percent)	Income in thousands of 1998 dollars									All in-comes
	Less than 10	10-20	20-30	30-40	40-50	50-75	75-100	100-200	200+	
Single earners:										
Less than 0	2,305	193	8	2	0	2	0	0	0	2,511
0-4.9	1,502	75	12	0	0	0	0	0	0	1,589
5.0-9.9	4,525	782	13	0	0	0	0	0	0	5,319
10-14.9	0	0	0	0	0	0	0	0	0	0
15.0-19.9	877	32	0	0	0	0	0	0	0	908
20-24.9	1,949	9,966	8,468	3,519	530	64	0	0	0	24,496
25.0-29.9	0	346	5	0	1	217	237	9	0	815
30-34.9	1,589	336	6	0	0	54	343	365	0	2,694
35.0-39.9	0	1,070	879	2,466	2,538	2,552	154	120	74	9,853
40-44.9	0	486	853	40	0	0	0	17	102	1,498
45.0-49.9	0	0	0	0	0	0	0	10	18	28
Total	12,747	13,285	10,245	6,027	3,070	2,889	734	521	195	49,712
Mean marginal tax rate										
Mean marginal income tax rate	5.6	23.3	25.7	28.1	33.4	34.8	32.5	35.0	41.2	21.5
Mean marginal Social Security tax rate	-2.1	15.7	18.0	20.4	25.8	27.8	29.8	32.7	39.2	14.0
	7.6	7.6	7.6	7.6	7.6	7.1	2.8	2.3	2.1	7.5
Married earners:										
Less than 0	919	252	41	6	1	0	0	0	0	1,219
0-4.9	139	49	21	5	2	0	0	0	0	216
5.0-9.9	639	1,057	123	47	2	0	0	0	0	1,868
10-14.9	0	0	0	0	0	0	0	0	0	0
15.0-19.9	158	60	18	7	6	59	3	0	0	311

45.0–49.9	0	0	0	0	2	2	0	0	0	36	279	320
Total	3,765	5,544	6,673	6,735	6,196	12,535	5,700	4,439	1,033	52,623		
Mean marginal tax rate	–22.6	22.8	37.2	23.3	22.8	26.7	34.4	34.5	43.1	25.0		
Mean marginal income tax rate	–30.2	15.2	29.6	15.7	15.2	19.1	27.9	29.4	39.7	17.8		
Mean marginal Social Security tax rate	7.6	7.6	7.6	7.6	7.6	7.5	6.6	5.1	3.4	7.2		
All earners ages 21–64 without Social Security earnings:												
Less than 0	3,224	446	49	8	1	2	0	0	0	0	3,730	
0–4.9	1,641	125	33	5	2	0	0	0	0	0	1,805	
6.0–9.9	5,163	1,838	136	47	2	0	0	0	0	0	7,187	
10–14.9	0	0	0	0	0	0	0	0	0	0	0	
15.0–19.9	1,035	91	18	7	6	59	3	0	0	0	1,220	
20–24.9	1,949	11,182	11,888	12,819	10,045	12,552	67	5	0	60,509		
25.0–29.9	0	1,555	473	28	8	446	1,602	1,430	0	5,541		
30–34.9	1,589	340	11	109	184	75	351	1,952	38	4,651		
35.0–39.9	0	1,521	2,011	2,527	2,570	11,129	8,720	5,335	186	34,000		
40–44.9	4	633	3,550	211	6	6	1	176	1,388	5,975		
45.0–49.9	4	0	0	2	2	0	2	69	721	801		
Total	14,610	17,732	18,170	15,763	12,827	24,270	10,746	8,968	2,333	125,419		
Mean marginal tax rate	3.5	22.5	28.4	25.0	25.4	28.8	34.6	34.7	43.0	25.2		
Mean marginal income tax rate	–4.2	14.8	20.8	17.4	17.7	21.2	28.1	29.5	39.5	18.0		
Mean marginal Social Security tax rate	7.6	7.6	7.6	7.6	7.6	7.5	6.5	5.2	3.5	7.3		

¹ In thousands.

Source: Congressional Budget Office tax simulation model.

FEDERAL TAX TREATMENT OF FAMILIES IN POVERTY

During the 1970s and early 1980s, inflation gradually increased the tax burdens of the poor and lowered the real income level at which a poor family became liable for income taxation. Legislation passed by Congress reversed or slowed this trend, but in the absence of indexing, inflation during this period gradually offset these legislative efforts. One measure of this trend is the degree to which the income at which a poor family begins to pay income taxes (termed the tax threshold, or the tax entry point) exceeds or falls below the poverty threshold. A second measure is the actual amount of tax liability incurred by a family with income at the poverty line.

Table 13–24 shows the income tax threshold, the poverty level, and the tax threshold as a percent of the poverty level for a married couple with two children in selected years. These figures demonstrate that before 1975 a family of four was generally liable for Federal income tax if the family's income was significantly below the poverty line. In 1975, following the enactment of the EIC, a

TABLE 13–24.—RELATIONSHIP BETWEEN INCOME TAX THRESHOLD AND POVERTY LEVEL FOR A FAMILY OF FOUR, SELECTED YEARS 1959–2007

Year	Income tax threshold	Poverty level	Tax threshold as a percent of poverty level
1959	\$2,667	\$2,978	89.7
1960	2,667	3,022	88.3
1965	3,000	3,223	93.1
1970	3,600	3,968	90.7
1975	6,692	5,500	121.7
1980	8,626	8,414	102.5
1984	8,783	10,610	82.8
1990	16,296	13,359	122.0
1991	17,437	13,924	125.2
1992	18,548	14,335	129.4
1993	19,187	14,763	130.0
1994	21,098	14,625	144.3
1995	22,362	15,570	143.6
1996	23,672	16,020	147.8
1997	24,386	16,479	148.0
1998	25,039	16,969	147.6
1999	25,798	17,470	147.7
2000	26,006	17,980	148.0
2001	27,333	18,521	147.6
2002	28,170	19,072	147.7
2003	29,035	19,654	147.7
2004	29,923	20,257	147.7
2005	30,833	20,880	147.7
2006	31,760	21,523	147.6
2007	32,742	22,187	147.6

Source: Congressional Budget Office.

family of four incurred no tax liability until its income exceeded the poverty threshold by 22 percent. Over the next decade this margin eroded; by 1984, a poor family of four incurred income tax liability when its income was 17 percent below the poverty line. By 1993, changes in the tax law resulted in no tax liability for a typical family of four until its income exceeded the poverty threshold by nearly 30 percent.

Table 13–25 shows the income tax burden and payroll tax burden of households with incomes at the poverty line for families of different sizes. As a result of the refundable EIC, the table reflects that many individuals receive a substantial credit that more than offsets total income, and in many cases Social Security, taxes paid.

TABLE 13–25.—POVERTY LEVELS, TAX THRESHOLDS, AND FEDERAL TAX AMOUNTS FOR DIFFERENT FAMILY SIZES WITH EARNINGS EQUAL TO THE POVERTY LEVEL, 1991–2007

Poverty or tax measure and year	Family size					
	1	2	3	4	5	6
Poverty level:						
1991	\$6,932	\$8,865	\$10,860	\$13,924	\$16,456	\$18,587
1992	7,143	9,137	11,186	14,335	16,592	19,137
1993	7,363	9,414	11,522	14,763	17,449	19,718
1994	7,547	9,661	11,821	15,141	17,900	20,235
1995	7,759	9,924	12,150	15,570	18,022	20,786
1996	7,982	10,211	12,501	16,020	18,542	21,386
1997	8,211	10,504	12,859	16,479	19,074	21,999
1998	8,456	10,816	13,242	16,969	19,641	22,654
1999	8,705	11,135	13,632	17,470	20,220	23,322
2000	8,959	11,460	14,030	17,980	20,811	24,003
2001	9,229	11,805	14,453	18,521	21,437	24,725
2002	9,504	12,157	14,883	19,072	22,075	25,461
2003	9,794	12,528	15,337	19,654	22,749	26,238
2004	10,094	12,912	15,807	20,257	23,446	27,043
2005	10,404	13,309	16,293	20,880	24,167	27,874
2006	10,725	13,719	16,795	21,523	24,912	28,733
2007	11,055	14,142	17,313	22,187	25,680	29,619
Income tax threshold:						
1991	5,550	10,000	16,179	17,437	18,616	19,794
1992	5,900	10,600	17,217	18,548	19,774	21,000
1993	6,050	10,900	17,841	19,187	20,405	21,624
1994	7,179	11,250	18,887	21,098	22,222	23,347
1995	7,356	11,550	19,387	22,362	23,426	24,491
1996	7,546	11,800	19,884	23,672	24,733	25,793
1997	7,800	12,200	20,488	24,386	25,488	26,590
1998	7,994	12,500	21,031	25,039	26,162	27,285
1999	8,257	12,900	21,678	25,798	26,963	28,128
2000	8,494	13,350	22,355	26,606	27,813	29,019
2001	8,735	13,650	22,956	27,333	28,561	29,788
2002	9,008	14,100	23,670	28,170	29,439	30,708

TABLE 13-25.—POVERTY LEVELS, TAX THRESHOLDS, AND FEDERAL TAX AMOUNTS FOR DIFFERENT FAMILY SIZES WITH EARNINGS EQUAL TO THE POVERTY LEVEL, 1991-2007—Continued

Poverty or tax measure and year	Family size					
	1	2	3	4	5	6
2003	9,289	14,550	24,400	29,035	30,345	31,656
2004	9,573	15,000	25,141	29,923	31,274	32,626
2005	9,860	15,450	25,902	30,833	32,226	33,620
2006	10,154	15,900	26,691	31,760	33,195	34,630
2007	10,451	16,400	27,515	32,742	34,219	35,696
Income tax at poverty level:						
1991	207	0	-1,192	-905	-591	-328
1992	187	0	-1,324	-1,053	-711	-422
1993	197	0	-1,434	-1,154	-780	-464
1994	83	0	-1,907	-1,795	-1,308	-895
1995	91	0	-1,957	-2,245	-1,749	-1,190
1996	99	0	-2,010	-2,627	-2,096	-1,497
1997	93	0	-2,065	-2,698	-2,152	-1,535
1998	105	0	-2,119	-2,770	-2,208	-1,573
1999	101	0	-2,182	-2,849	-2,270	-1,616
2000	105	0	-2,246	-2,935	-2,339	-1,667
2001	112	0	-2,312	-3,023	-2,409	-1,717
2002	112	0	-2,382	-3,112	-2,479	-1,766
2003	114	0	-2,453	-3,203	-2,552	-1,817
2004	118	0	-2,525	-3,299	-2,627	-1,870
2005	123	0	-2,601	-3,399	-2,706	-1,926
2006	129	0	-2,683	-3,500	-2,786	-1,982
2007	137	0	-2,765	-3,609	-2,874	-2,044
Payroll tax at poverty level:						
1991	530	678	831	1,065	1,259	1,422
1992	547	699	856	1,098	1,298	1,466
1993	563	720	881	1,129	1,335	1,508
1994	577	739	904	1,158	1,369	1,548
1995	594	759	929	1,191	1,379	1,590
1996	611	781	956	1,226	1,418	1,636
1997	628	804	984	1,261	1,459	1,683
1998	647	827	1,013	1,298	1,503	1,733
1999	666	852	1,043	1,336	1,547	1,784
2000	685	877	1,073	1,375	1,592	1,836
2001	706	903	1,106	1,417	1,640	1,891
2002	727	930	1,139	1,459	1,689	1,948
2003	749	958	1,173	1,504	1,740	2,007
2004	772	988	1,209	1,550	1,794	2,069
2005	796	1,018	1,246	1,597	1,849	2,132
2006	820	1,049	1,285	1,647	1,906	2,198

TABLE 13–25.—POVERTY LEVELS, TAX THRESHOLDS, AND FEDERAL TAX AMOUNTS FOR DIFFERENT FAMILY SIZES WITH EARNINGS EQUAL TO THE POVERTY LEVEL, 1991–2007—Continued

Poverty or tax measure and year	Family size					
	1	2	3	4	5	6
2007	846	1,082	1,324	1,697	1,965	2,266
Combined tax at poverty level:						
1991	738	678	– 362	160	668	1,094
1992	734	699	– 467	45	587	1,044
1993	760	720	– 552	– 25	555	1,044
1994	661	739	– 1,003	– 637	62	653
1995	685	759	– 1,027	– 1,054	– 371	400
1996	709	781	– 1,054	– 1,402	– 678	139
1997	721	804	– 1,081	– 1,437	– 692	148
1998	751	827	– 1,106	– 1,472	– 705	160
1999	767	852	– 1,140	– 1,512	– 723	168
2000	791	877	– 1,173	– 1,560	– 747	169
2001	818	903	– 1,207	– 1,607	– 769	175
2002	839	930	– 1,244	– 1,652	– 790	182
2003	864	958	– 1,280	– 1,700	– 811	191
2004	890	988	– 1,316	– 1,749	– 834	199
2005	919	1,018	– 1,355	– 1,801	– 857	207
2006	950	1,049	– 1,398	– 1,853	– 881	216
2007	983	1,082	– 1,441	– 1,912	– 909	222
Combined tax at poverty level as a percent of poverty level:						
1991	10.6	7.6	– 3.3	1.1	4.1	5.9
1992	10.3	7.7	– 4.2	0.3	3.5	5.5
1993	10.3	7.7	– 4.8	– 0.2	3.2	5.3
1994	8.8	7.7	– 8.5	– 4.2	0.3	3.2
1995	8.8	7.7	– 8.5	– 6.8	– 2.1	1.9
1996	8.9	7.7	– 8.4	– 8.8	– 3.7	0.6
1997	8.8	7.7	– 8.4	– 8.7	– 3.6	0.7
1998	8.9	7.7	– 8.4	– 8.7	– 3.6	0.7
1999	8.8	7.7	– 8.4	– 8.7	– 3.6	0.7
2000	8.8	7.7	– 8.4	– 8.7	– 3.6	0.7
2001	8.9	7.7	– 8.3	– 8.7	– 3.6	0.7
2002	8.8	7.7	– 8.4	– 8.7	– 3.6	0.7
2003	8.8	7.7	– 8.3	– 8.6	– 3.6	0.7
2004	8.8	7.7	– 8.3	– 8.6	– 3.6	0.7
2005	8.8	7.7	– 8.3	– 8.6	– 3.5	0.7
2006	8.9	7.7	– 8.3	– 8.6	– 3.5	0.8
2007	8.9	7.7	– 8.3	– 8.6	– 3.5	0.7

Source: Congressional Budget Office.

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